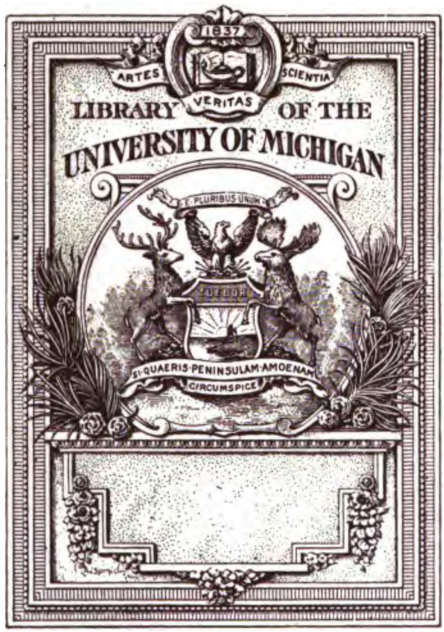
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AUDITING

BY

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Preface.

This volume contains all questions set in the Auditing paper at the New York State semi-annual examinations for certified public accountants from December, 1896 (the date of the first examination held), to June, 1902, inclusive, with full answers and explanations.

The student can gather from these answers certain general principles; the application of them can only be learned by practical experience under the direction of a public accountant and auditor.

Attention is specially called to a most admirable paper by Mr. Arthur Lowes Dickinson, M. A., F.C.A., C.P.A., on "The Profits of a Corporation," read before the Congress of Accountants at St. Louis recently. It contains information on specific points too often overlooked by the irreflective, treated in detail in an eminently practical manner. An article on "Auditing Insurance Accounts," by Mr. George Wilkinson, C. P. A., will well repay attentive perusal. Both of these papers are published in "The Business World."

Since the publication of the previous volumes of this series ("The Theory of Accounts" and "Commercial Law"), an excellent work on Executors' Accounts has been written by Mr. Joseph Hardcastle, C. P. A., Professor in the School of Commerce, Accounts and Finance of New York University. It should be in the hands of every student who desires to familiarize himself with this important branch of accounting and auditing.

The last volume of this series, "Practical Accounting," will be published in April, 1905.

The following works have been consulted in the preparation of this book:

"Auditing,"..................L. R. Dicksee, F. C. A.
"Auditing,"....................F. W. Pixley, F. C. A.
Executors' Accounts...........J. Hardcastle, C. P. A.
Encyclopædia of Accounting, George Lisle, C. A., F. F. A.
Accounting in Theory
and Practice..........George Lisle, C. A., F. F. A.

My best thanks are due to Mr. Howard Greenman, C. P. A., author of "Reversible Cotton Tables," for his kindness in reading over the proof-sheets of this volume.

FREDERICK S. TIPSON.

December 15, 1904.

December, 1896.

I. Give a brief outline of the duties of an auditor and of his responsibilities.

The duties of an auditor are to examine and pass in review the work of others with the object of determining its accuracy as evidenced by absence of

(*a*) Fraud;
(*b*) Technical errors;
(*c*) Errors of principle.

This involves a complete examination of all the books of accounts; the passing upon the propriety of the various charges and credits appearing in the revenue account; and finally the ascertaining of the exact state of a client's affairs upon a certain given date as exhibited in a Balance Sheet, to the correctness of which he can certify.

His responsibilities vary considerably as to the extent to which he would have to inspect subsidiary books, contracts, etc., in the case of the audit of a corporation, or partnership, and for individuals. But in general, he is responsible for the accuracy of the figures to the correctness of which he certifies, and for the failure to detect fraud; taking nothing for granted, he should verify everything.

II. Explain the principal points to which an auditor should direct his attention in conducting the audit of an incorporated company.

The auditor should first ask for the minute book, which should contain a copy of the corporation articles of incorporation, and the by-laws.

Having carefully studied these he should see that proper "opening" entries have been made in the journal, and that the stock ledger and transfer book have been properly written up. The knowledge he has now gained will enable him to act with intelligence in determining from his examination of the books of account whether the stockholders' rights have been duly preserved.

He should next see

(*a*) That the inventory has been taken at cost price, unless said price is ***higher*** than market value, in which case it should be figured at market value (on the principle that it is generally advisable to "cut losses and let profits run"; and that it is made out and signed by the employees who "took" it;

(*b*) That capital and revenue expenditure have been properly classified;

(*c*) That the profit and loss account has been charged with a proper percentage of depreciation off items subject to wear and tear, and that proper provision has been made for discounts, bad debts, and also all items of incomes due and unpaid up to date of closing the books;

(*d*) That the balance sheet states the assets under proper descriptive titles at fair value, and that the liabilities are stated in full;

(*e*) Finally, if dividends have been declared that they have been paid out of surplus and do not work an impairment of capital.

The student will find that a thorough knowledge of corporation law is absolutely indispensable to the effective auditing of corporation books.

III. If the actual cash on hand at the date of the balance sheet had not been verified by the auditor on the day

of balancing, what method should be employed to prove its correctness before signing the accounts?

He should count the actual cash (currency) on hand, and list undeposited checks after seeing that they are all entered in the cash book. These amounts added to the balance in bank as shown by the check book should agree with the cash book balance. Having personally deposited cash and checks in bank, he should leave the pass-book to be written up, requesting that it be delivered to himself personally. As soon as he secures the pass-book with cancelled checks, he should draw up a reconciliation account by deducting uncleared checks from pass-book balance, so as to agree pass-book with check book. Then by checking back all receipts, deposits and payments to date of balance sheet he can verify the cash balance which appears there.

IV. In an audit where an exhaustive, detailed examination of the books is not stipulated or not practicable, what examination is essential to insure their general correctness?

The cash book should be checked as to footings and postings.

Cash payments should be vouched and the pass-book balance at date of closing reconciled with the balance shown in the cash book.

Next, the footings of all books of original entry should be carefully gone over and occasional test checks made of postings.

If controlling accounts for sales and purchase ledgers do not exist, they should be constructed; so as to verify

the aggregate amount due by customers and due to creditors.

The closing entries should be examined and checked to see that the profit (if any) is neither under nor overstated.

Lastly, the balance sheet should be taken in hand to see that it is a fair expression of the Assets and Liabilities of the business as of the date it bears on its face.

V. What means should be employed to detect the wilful omission to enter in the books under audit sales made or cash received?

Probably the most effective method to detect such omissions would be for the auditor to forward to all customers on the books complete statements of their accounts for the period under investigation; requesting that they be returned to him personally at his official address with notification of errors or omissions. This is an extreme measure, but a most effective one, worthy of more frequent adoption.

Where consecutively numbered receipts with corresponding stubs are used, the detection of the omission of cash receipts would be a comparatively easy matter; but where they are not, the effectiveness of the auditor's work must largely depend upon the system of internal check employed.

The omission of sales would only be made with the object of appropriating the cash paid for same, and it must be admitted that this could be done occasionally without much chance of detection. Should the omissions be continous and of large amounts, the decreased percentage of gross profit in the trading account would

call for special investigation. Like falsification of pay-rolls, by the adoption of proper system the danger may be reduced to a minimum, the prevention being a comparatively simple matter, the detection later on one of considerable difficulty.

VI. State what should be required of a company or firm by one who is to make an audit of its books.

When the audit is to be made unexpectedly, with the object of ascertaining whether irregularities have been committed by any of the employees, the auditor will have to " take things in the condition he finds them in" and trust to his own experience, sagacity and ingenuity to suggest the proper method of conducting what might be more aptly called "the examination."

But where the audit is entered on at the end of a fiscal period, he should require the production of an accurate trial balance (as formal evidence of the books having been in balance before they were closed), a Profit and Loss Account and Balance Sheet.

He should obtain a list of all Books of Account and the names of the staff by whom kept. He should label them so as to indicate the period covered by their contents. He should require that all vouchers be arranged in order; that the stock sheets be producable, signed by the parties who made them out.

Bonds, mortgages and other evidences of existing assets in all forms should be listed and produced for inspection simultaneously. The cash should be balanced, all cash deposited, and the pass-book and cleared checks arranged in proper order for examination. In the case of a corporation, he should also ask for the Minute Book

and request that the Stock Certificate Book, Transfer Book and Stock Ledger be written up and available for examination if necessary.

VII. What evidence should be required as to the correctness of values of assets (other than customers' accounts) entered in the books?

With regard to securities such as Stocks, Bonds, etc., the instruments themselves should be produced. They should be listed and compared with public price lists (where they exist), or with such evidence of value from various sources as may be otherwise procurable.

As to real property, the title deeds themselves should be carefully examined, and corroborative evidence as to value obtained from real estate men, etc., to see that if the book value is above price actually paid, it is warranted by existing conditions.

With regard to plant and machinery, the account should be carefully scrutinized to see that repairs and renewals have not been added to original cost. Original bills should be produced and great care taken to see that adequate provision has been made for depreciation.

As to the inventory of stock of goods on hand, it should be signed by the parties who took it. Extensions and footings should be checked, and if the gross profit on sales evidenced by the Merchandise or Trading Account exhibits a marked increased or decreased percentage, a special investigation might be necessary.

Rights and franchises, goodwill, patents, and organization account should be thoroughly gone into so that there could be no possible doubt, after the auditor's certificate is given, in the mind of any interested person, as to the

real meaning and value of any item coming under these "fancy" designations.

VIII. State what is necessary in auditing cash payments, and how to prevent the reproduction and passing of vouchers a second time.

In auditing cash payments the utmost care should be exercised to see that proper evidence of payment is furnished by checks returned from the bank with pass-book, by receipted bills, and by proper authorization and entry in cash-book. The auditor can generally succeed in arranging that all cash payments be made by check, except items paid through the petty cash book, and that no Ledger accounts be paid through that source. A little ingenuity will suggest methods of obtaining satisfactory vouchers even for petty cash expenditures.

The auditor can prevent the reproduction and passing of vouchers a second time by signing or stamping his name or initials on the "paid" portion of the voucher in colored ink. Where the effacement of vouchers is not permitted, the auditor should have all vouchers produced simultaneously and retain them all in his possession until his cash audit is completed.

IX. State what examination should be made of the receivable book accounts of a firm or company to ascertain what accounts, if any, should be written off as bad.

The auditor should request the attendance of some member of the firm or some responsible officer of the corporation, and in his presence examine every account receivable open on the ledger to ascertain:

1st, that every balance consists of certain unpaid-for bills;

2nd, that no old differences which should have been written off are included;

3rd, that no old bills remain unpaid while recent ones have been settled, unless satisfactory explanation is forthcoming;

4th, that no account is included as good which is barred by the statute of limitations;

5th, that balances due by insolvent firms are transferred to doubtful accounts; and

6th, that where outstanding balances be found of unusually large amounts, the standing and credit of the firm be carefully ascertained. This latter precaution is especially valuable where accounts have been partly closed by notes receivable, which remain in the safe, or on which there is contingent liability if discounted.

X. How may it be determined whether certain expenditures of a manufacturing business were of the nature of maintenance and repairs or constituted an actual betterment of the plant? State how in each case they should be dealt with in the balance sheet and in the profit and loss account.

The determining factor should obviously be the nature of the work for which the expenditure was made. If the work performed was rendered necessary to maintain plant and machinery in its primary state of efficiency, the item would come under the head of repairs and should be charged to profit and loss account. But if, on the other hand, the efficiency of the plant as to output were increased, then the work done would be in

the nature of a betterment; it should be charged to Plant and Machinery and appear under that heading in the balance sheet.

XI. In auditing the accounts of a business for the first time, what books should be produced? What would be the first duty of the auditor respecting these books?

The auditor should require the production of all the books of account, and all subsidiary books to which reference could possibly be rendered necessary in the period under review.

His first duty respecting them would be to list them with descriptive designations and particulars as to periods covered by contents, and the names of the employees by whom kept. He should then initial each book to enable him positively to re-identify it if necessary. In this way books cannot be abstracted or withheld after original production without his knowledge, and he will be able to swear whether he has or has not examined a particular book submitted to him.

XII. In auditing the accounts at the conclusion of the first fiscal year of a corporation formed to acquire an established business, what documents and records should be examined in addition to the ordinary books and subjects of an audit?

The auditor should first call for the minute book, which contains a copy of the articles of incorporation. From this he can determine the amount of its authorized capital, the nature and scope of its business, the date of its formation, etc.

He should then ask for copies of all contracts between

the vendors and the corporation, see that same have been duly authorized by recorded resolutions, and ascertain that proper expression has been given to same in the financial books.

The stock certificate book, the transfer book and the stock ledger should be carefully gone through to see that all contracts in regard to issuance of capital stock have been carried out, and that all transactions in regard thereto have been perfectly regular.

Finally, all deeds of realty, etc., acquired by the corporation should be carefully gone over with a view to seeing that their value is duly recorded on the books, together with any liabilities given or assumed on same.

XIII. To what extent should an auditor hold himself responsible for the correctness of (*a*) inventories, (*b*) pay-rolls, (*c*) depreciations and discounts?

(*a*) The auditor should hold himself responsible for the extensions and footings of inventories, and state in his certificate that he has accepted quantities and prices on the authority of the signatories. It would be proper for him to urge that the valuation obtaining should be market price if same is less than cost price, and cost price if same is less than market price.

The constancy or variability of the percentage of gross profit in the Trading Account should be of great value in determining the prima facie value of the reliability of the inventory.

(*b*) With regard to pay-rolls, the auditor can check time worked from foreman's book into pay-roll sheet, check calculations at given rate of wages, check footings of pay-roll sheets, and see that the final total agrees

with the amount of check drawn for wages. He should make careful enquiry as to the method pursued in making up pay-roll and paying off, and pay particular attention to any obvious weak spots in the system.

(*c*) As to depreciation, he should see that a proper percentage has been written off all assets subject thereto, and should, in his judgment the rate fixed be insufficient, and the directors of a corporation object to the alterations he recommends, he should draw attention to the matter in his report and in the certificate he appends to the balance sheet. In the case of a firm or sole-trader, his responsiblity would end after he had called attention to the fact. But even in this latter case, the auditor should remember that his statement may be used as a basis for procuring trade credit and bank accommodation, and that unless he uses the utmost circumspection he may be made the instrument of misrepresentation.

Discounts may be checked by checking total cash paid and received, and seeing that the average percentage allowed and received on settlements is approximately correct.

XIV. In an audit stipulating for the examination of all vouchers of every description, what would be proper vouchers for the following: purchases, returned purchases, sales, returned sales, cash receipts, cash payments, journal entries?

For purchases paid for, the proper vouchers would be receipted bills; those unpaid for should be verified by the production of the invoices on file. Both receipted and unreceipted bills should be initialed or stamped, showing that the purchases were authorized and that the

goods had been received. Where a stock book is kept, the invoices should be checked with the entries therein.

Return purchases recorded in the return book should be vouched for by credit memoranda, supported by correspondence, transport receipts, etc. Reference should also be made to the original purchase invoices.

The best vouchers for sales are the original order blanks, signed delivery receipts, stock book entries, and bills of lading.

Returned sales should be vouched for by evidence of receipt, correspondence, stock book entries, and reference to the original bill.

Cash receipts should be vouched for by stubs of receipt book, evidence of deposit in bank, cash-book entries, ledger postings, etc.

Cash payments can be vouched for by receipted bills, receipt forms, checks and notes which have passed through the bank properly endorsed, pay-rolls properly checked and signed, etc.

Journal entries should be supported by journal vouchers, duly authorized, and by a consideration of the facts recorded.

XV. On what basis should the following assets be valued in the preparation of a balance sheet: (*a*) manufactured goods, (*b*) partially manufactured goods, (*c*) raw material, (*d*) open book accounts receivable, (*e*) stocks, bonds and other investments, (*f*) bills receivable?

(a) Manufactured goods should be valued at cost, i. e., cost of raw material, labor, freight, and a proper percentage of management expenses.

(b) Partially manufactured goods should be valued

on the basis of manufactured goods according to the amount of material used, labor expended, etc., upon them.

(c) Raw material should be valued at cost or market, whichever is lower, to which should be added all expenses attending acquisition.

(d) Open book accounts should be valued as per ledger balance, care being taken to see that proper reserve is set aside for bad debts, discount, etc.

(e) Stocks, bonds, and other investments should be taken at cost unless same is above market price, when they should be valued at market quotations.

(f) Bills receivable, if good, should be taken at face value.

June, 1897.

I. State the objects to be attained by an audit.

The objects of an audit are, briefly,

(1) The detection of fraud.

(2) The detection of technical errors.

(3) The detection of errors of principle.

As fraud can only be concealed by a technical error or an error of principle, it is obvious that an audit involves a complete examination of the books; the verification of the revenue account to ascertain that the profit or loss for a fiscal period shown therein is correct; and the reviewing all the items appearing upon the balance sheet, so that the auditor may be able to certify that neither assets nor liabilities are over or under-stated.

II. How should one proceed in order to ascertain that all the libilities are shown in a balance sheet?

The primary proof that all liabilities are shown is to be found in the confirmation of the result disclosed in the revenue account being corroborated by the corresponding increase or decrease of assets over or under liabilities in the balance sheet; but it is a primary or mathematical proof only.

With regard to the item "accounts payable," invoices of merchandise may have been entered in the stock book and included in the inventory, but yet not passed through to the credit of the vendors on the books. This, were the items large, would cause an increased

percentage of gross profit in the trading account, and a careful examination would bring to light the omission.

Again, returned merchandise by customers may have been included in the inventory and not passed through the books to their credit. The result would be the same, and could be proved by correspondence, dates in receiving book, and names and dates in "returns" book.

Bills payable for loans could be proved by cash and bank pass book entries. Notes receivable if discounted and unpaid would have to appear as contingent liabilities. The test of correctness would be reference to cash and note books.

Next would come the item of accrued liabilities. Rent, wages, interest on bonds and mortgages, and interest on loans would come under this heading, for the determination of the accuracy of which reference would have to be made to subsidiary books and documents.

Finally, the matter of reserves for bad debts, discounts, and depreciation (if not already charged off) would call for consideration, and their correctness would be easy of determination where the audit has been conducted on scientific lines.

There would be considerable variation in specific cases, and the auditor should in each bring his general experience to bear upon the matter.

III. State briefly and in order of procedure the different steps to be taken in auditing a bank.

Each department of a bank should be taken separately.

The auditor should commence by counting the cash in the possession of the Receiving Teller and see that it agrees with his "proof." All deposit checks on other

banks should be listed and amounts agreed with those appearing on clearance-house sheet. The checks on hand drawn on the bank under examination plus those on other banks deposited during the day, together with cash, should equal the total amount of deposits received.

Proceeding to the Paying Teller's department he should count cash and see that it agrees with his "proof." He should next list and total checks paid out during the day, seeing that the amount agrees with his books. Clearance-House transactions should be carefully examined, and the auditor should be most particular to see that the amount of checks on hand plus the total amount of checks paid out by the Teller during the day and the amounts charged to other departments and Teller's agrees with the amount of cash he claimed to have had on hand at the close of the preceding day's business.

The discount department should next be visited. Bills discounted should be examined, listed, and agreed with the General Ledger balances; those sent away for collection, acceptance, etc., may be proved by correspondence, etc. Special attention should be called to notes past due, as well as to collateral loans not covered by proper margin.

The depositors' ledgers total balances should agree with the amount shown in the general ledger. The day's deposits should be examined and compared with the Receiving Teller's sheet; notes discounted and drafts collected should be checked with the discount and collection registers; and checks charged should agree with Paying Teller's Sheet.

Finally the general ledger should be proved; all securities called for by the balances examined and counted,

care being exercised to secure simultaneous production. The auditor should at the same time personally write to the bank's agents and correspondents requesting them to advise him at his office address of the amounts due by them at the close of business on the day of the examination, and on receiving replies a careful comparison should be made. The account with the U. S. Treasurer may be proved by his letters of advice; the circulation received from Washington should be verified also, while certificates of deposit should be proved from the certificate book and register.

As in every other business, the correctness of earnings should be proved, and care taken to see that the assets and liabilities on the bank balance sheet at the close of the business day on which the examination is made are neither over nor under stated.

IV. How should the interest received on a bond bought at a premium be treated?

Such a proportionate portion of the interest should be credited to the Bonds Purchased Premium account periodically as will wipe out the total premium by the time the bond matures and is paid at par. The balance of the interest received should be periodically credited to bond interest account, which in its turn is of course credited to revenue account as interest on investments.

V. Should a reserve fund be invested in interest bearing securities? State the custom. If so invested what account should be credited with the income?

It should.

It is the custom to set aside periodically and invest in quickly realizable securities from time to time, such

amounts as may be deemed necessary for the purpose for which the fund is to be created.

The interest received on the investment is either re-invested, thereby increasing the fund, or is credited to the revenue account under the head of interest on investments.

Where it is desired to raise a fund of a certain amount in a certain number of years, such a proportionate amount may be invested annually as will in the given time (without interest) equal the given amount. In this case the interest should be credited to revenue account. On the other hand, it may be deemed desirable to invest periodically such a sum as will at a given rate of compound interest equal the amount desired in a given time. Here, of course, the interest is, perforce, re-invested.

VI. In an audit of the accounts of a firm or of a corporation, how may the cash as shown by the bank pass-book be reconciled with the amount called for by the cash-book or ledger? After this course has been taken, is it necessary to check the pass-book with the deposits as shown by the cash-book? What might such detailed checking show?

The cash balance, as shown by the bank pass-book, may be reconciled with the amount called for by the cash-book or ledger by deducting from the pass-book balance the amount of all checks charged in the cash-book and deducted from the check-book balance, but not returned by the bank.

After this course has been taken, it is still necessary to check the pass-book with the deposits as shown by the cash-book, both as to amounts and dates. Such detailed checking might show that the amounts were not deposited

on the dates stated in the cash-book. The cashier's balance might be correct in the aggregate at the time of balancing, but wrong at times between balancing—the inference being that he was making temporary use of cash for his own purposes.

VII. How may fraud in payment of wages be detected?

As direct evidence of proper payment is almost impossible, the auditor should first thoroughly master the *system* employed, noting carefully any weak places and pay greatest attention to them. He should check the foremen's books with the pay-roll as to time, and amount charged for piecework. He should then go carefully over the calculations, check the footings of the pay-roll book, and see that the total agrees with the amount of the check drawn for wages. It may be admitted at once that fraud in the payment of wages is very difficult to detect after perpetration, but comparatively easy to prevent by the adoption of proper precautions. These consist in dividing the work of making up the pay-roll as much as possible. The calculations and footings should be done by one clerk, checked by another, the pay-roll check made out by cashier, and cash actually drawn by him from the bank, the money put into separate envelopes by two other clerks, and the actual handing over the envelopes performed by others. Successful fraud would here necessitate so much collusion amongst employees as to be considered a remote contingency.

VIII. In a statement of the earnings of a business to be sold on the basis of its earning capacity, how should the question of interest paid on accounts payable, on bills payable and on loans be treated?

Inasmuch as these payments would indicate generally the want of adequate working capital, and inasmuch as such charges would have the effect of lessening the book-earning capacity of a business, these items should be placed in a separate section of the revenue account, so that the real earning capacity of the business might be clearly seen. The interest thus paid could be available for profit sharing were these charges not rendered necessary.

IX. State a method of procedure in an examination of securities consisting of bonds, stocks and bills receivable.

The method pursued should be as follows: The auditor should see that the bonds and stock certificates—all of them—be produced at the same time. He should examine them, list, and total their face value. He should next compare them with market quotations. Bonds having a redeemable value at a certain time, should be taken at cost—care being exercised to see that due provision had been made for the proper application of interest—whether bought at a premium or at discount.

Stocks, as regards valuation for a balance sheet, would require rather different treatment. If market quotation be above cost, the stock certificates may be taken at purchase price; if below, the valuation of stocks should be written down to market value.

Bills receivable should be either on hand or in the bank for collection. Those on hand may be verified by examination; those at the bank for collection, by the auditor asking for a certified list of the notes in the possession of the bank for collection.

As to their valuation, attention would have to be paid to the credit of makers and endorsers as evidenced by general enquiry and reference to credit books, etc.

X. In an audit of a railway company's accounts, how should it be determined that the net earnings are correctly stated?

In order to determine this point it would be necessary to make such an investigation as would satisfy the auditor that the gross earnings for the period under review, less operating expenses, including taxes, were correctly stated.

As to earnings, the returns from the following sources would call for verification:

Foreign roads, tickets and mileage;

Earnings: passenger, freight, mail, express, and miscellaneous. Special care would have to be exercised that all earnings taken credit for belonged to the fiscal period under examination.

With regard to operating expenses, satisfactory vouchers should be called for for all expenditure divided among the various classifications of conducting transportation; for the maintenance of way and structures, and for the maintenance of equipment, as well as items coming under the head of general expenses.

Finally, the utmost vigilance would have to be exercised to see that no expenditure properly chargeable to revenue had been capitalized.

XI. State what items may properly be charged to construction account, after a railway has been in operation for some years.

New road-beds, new buildings, new side-tracks less cost of those taken up, new bridges, culverts and viaducts, new rails less cost of old ones. These are the principal items. If the company's stocks and bonds are sold at a discount to raise funds to be applied to construction, the construction account should be charged with the amount of the discount.

XII. In the books of a railway company what provision should be made for destroyed equipment?

The income account should be periodically charged and a reserve account credited with a certain percentage of original cost of equipment.

In this way the earnings will not vary by reason of extraordinary expenditure rendered necessary by accidents, etc.

XIII. Give the headings for a condensed balance sheet of the accounts of a railway company.

ASSETS.	LIABILITIES.
Original Cost of Road.	Capital Stock, Common.
Construction of Branches.	Capital Stock, Preferred.
Betterments.	Bonds.
Equipment.	Vouchers.
Express Equipment.	Pay-Rolls.
Real Estate.	Accrued Interest on Bonds.
Materials and Supplies.	Bond Coupons.
Agents and Conductors.	Accrued Taxes.
Individuals and Companies.	Accrued Rental of Leased Lines.
U. S. Govenment.	Express Money Orders.
State and County Warrants.	Traffic Balances.
Securities in the Treasury.	Sundries.
Sundries.	Dividends Unpaid.
Cash.	Equipment Renewal Fund.
	Renewal Fund.
	Undivided Profits.

XIV. What test should be made of the prime cost of manufactured goods to guard against loss of raw material through theft by employees?

The auditor should first ascertain what (if any) system of internal check is employed.

All purchases of raw materials and supplies should be checked into stock-keeper's books from invoices, and thence into the consumption books. Labor should be checked also into the consumption book.

If accurately kept any shortages due to theft would be apparent as soon as the inventory was made up. This may be illustrated as follows:

1904.	RAW MATERIAL ACCOUNT.	
January 1.	To Inventory	$5,000.00
June 30.	Purchases to date	25,000.00
		$30,000.00

1904.		
June 30.	By consumption to date	$20,000.00
" 30.	Inventory	6,000.00
	Shortage to be accounted for.	4,000.00
		$30,000.00

If the inventory at the beginning of the period was $5,000 and $25,000 was purchased, the $30,000 would have to be accounted for.

If $20,000 was consumed and $6,000 remained in hand, $4,000 worth of raw material would have to be accounted for.

It would be necessary for the auditor to see that there were no mistakes in calculation and that proper allowances had been made for manufacturing shrinkage and waste.

Where cost accounts are not kept, the decreased percentage of gross profit in the trading account would put the auditor on the alert and he would have to construct for himself such accounts from existing records as would enable him to arrive at the same approximate results.

XV. In an inventory how should stock purchased on credit, subject to usual discounts, be valued?

Trade discounts should be deducted from purchase price, but cash discounts should not, as there is always a possibility that there may be insufficient cash on hand on a particular day to enable advantage to be taken of such discount.

December, 1897.

I. State briefly a proper course of procedure for making a correct audit of the books and accounts of (*a*) a manufacturing business, (*b*) a fire insurance company, (*c*) a bank.

(*a*) In auditing the books of a manufacturing business, special attention should be paid to those points wherein it differs from an ordinary trading concern. As in every other audit, the cash book should be checked exhaustively. All receipts should be traced into the bank; all payments verified by vouchers; all footings and postings checked; and the balance on hand agreed with the pass-book at the close of the period under review by the construction of a reconciliation account.

The footings of all books of original entry should be checked, and where possible the postings also.

The trial balance should be proved; the closing entries into the profit and loss account rigidly scrutinized; and finally the balance sheet made up and certified to.

The above procedure is common to the audit of most businesses; but in a manufacturing business the pay-roll should be carefully checked, and where cost accounts are kept, the purchases, consumption, and final inventory of raw material should be gone over.

(*b*) In the audit of the books of a fire insurance company the total amount of income receivable should be first ascertained and verified from the Policy Book and the Renewal Register. If renewal receipts are given for

all existing policies, the unused receipts should be produced as vouchers for policies discontinued. If blank receipts are used at the head offices and at the branches and agencies the number of receipts issued, used and returned should be compared with the number of renewals and discontinuances. When the gross amount receivable is found, the insurance discontinued can be verified, and the net amount receivable arrived at.

The amount of cash received as premiums, less the outstanding balances at the commencement of the period, will agree with the net amount receivable, less the balances outstanding at the time of closing the books.

The auditor should obtain a list of these balances and see that they have been received since closing the books, or that the agents have acknowledged the amounts to have been received by them.

Re-insurances call for careful examination, and attention should be given to the reserve for same.

The cash book should be checked and vouched; the claim book examined, and care exercised to see that proper provision has been made for claims in process of adjustment.

As in other financial institutions, the Balance Sheet calls for special consideration, so that the auditor may be able to certify that the assets are neither over nor under-stated, and that all the liabilities have been taken into account.

(*c*) The method of auditing the books and accounts of a bank have been explained fully in the answer to question number III, June, 1897, to which the reader is referred. It will be well for the auditor to bear constantly in mind the fact that his responsibility is not confined to

the mere safeguarding of the interests of the stockholders of the bank: his certificate is, or should be, a virtual guarantee to the public that the accounts to which his signature is attached may be accepted and relied upon as correct in every respect.

II. The check-book of a company shows cash in bank \$12,500, the bank pass-book for the same date shows \$14,000; which is correct and which amount should be included in the balance sheet?

The amount to be included in the balance sheet is \$12,500, as it is assumed (actual verification having been made by the auditor) that the total amount of checks made out and charged through the cash-book but not yet presented for payment at the bank is \$1,500, which added to the \$12,500 makes up the \$14,000 shown in the pass-book.

III. Under what circumstances should deduction be made for depreciation? What classes of assets are most subject to depreciation?

Deduction should be made for depreciation wherever the asset is subject to a continual decline in value through subjection to "wear and tear," as in the case of plant and machinery; or through expiration of value, as in the case of leases, etc.

Fixed or capital assets are most subject to depreciation —but each item must be considered on its own merit. Thus, while the plant and equipment of a railroad would be constantly depreciating in value and call for constant renewals, the construction account might actually increase in value for various reasons.

IV. An insurance company buys for investment $50,000 7% 10-year bonds at 116. Should this purchase be entered in the balance sheet at par or at cost price? If the latter, what should be done with the premium, in view of the fact that the bonds will be paid off at par at the expiration of 10 years?

The investment should be entered in the balance sheet at cost price. The premium here (500×16=$8,000) has to be wiped out in ten years. The income is (500×7 =$3,500)—of which $800 annually should be credited to the premium account and the balance, $2,700, to the "income from investments" accounts. It will be well to bear in mind that while this is a *practical* answer to the question the income on the investment is not 7%; as the bonds cost 116. Provision has to be made for the loss of interest on the premium, which decreases year by year. A reference to tables specially constructed for this purpose will show at a glance the amount actually necessary to be set aside out of income to provide for this item.

V. In the case of an audit of the books of a corporation where the volume of transactions is so large that a detailed checking of all postings and footings is out of the question, what course should be pursued in the examination in order to insure the correctness of the balance sheet?

As in all other audits, cash receipts and expenditures should be checked exhaustively; cash book footings and postings gone over, and vouchers examined.

The footings of all books of original entry should be gone over and the income and expenditure accounts checked. If controlling accounts for customers and

creditors exist, they should be verified and without further detailed checking may be accepted as the correct items for accounts receivable and payable on the balance sheet. The profit and loss account should be gone over and care exercised here that proper amounts have been written off for bad debts, discounts, depreciation, etc. Each item on the balance sheet will then call for the same consideration as is necessary in a complete and detailed audit. The student will see at once how enormously the work may be curtailed by the controlling accounts. Should they not exist the auditor would of course have to construct them.

VI. If in the course of an audit it should be found that capital expenditures had been charged up against profit and loss account, or items of expense against improvement account, what would be the duty of the auditor in respect to such charges?

In each case it would be the duty of the auditor to reverse the entries and charge them to their proper accounts. As such corrections would involve an alteration in the profit shown he should draw attention to the matter in his report, so that no one may be misled by the fluctuation; but if his audit is made prior to the closing of the books this would not be necessary.

VII. How should goods sent out on consignment be treated in the books of a company? When the goods have been sold and the consignee sends in his account sales, what entries should be made to give effect to the transactions?

The goods sent out on consignment should be credited to the merchandise account at cost and charged to a consignment account under the name of the consignee.

When he renders the account sales the consignee charges himself with the sales price of the goods and credits himself with expenses incurred, commission, and the cash he remits in settlement. The consignor now credits the consignment account with the sales price and charges a personal account with consignee with same; credits account of consignee with expense and commission and charges same to consignment account; credits cash remitted to consignee's account (thus balancing it) and charges his own cash account with same. Should the credit side of the consignment account exceed the debit side the difference is the profit on the transaction which should be debited to the consignment account (closing it) and credited to the merchandise account as profit on consignment.

VIII. If any payments are received by a company on account of work in process, how should such payments on account be shown in the balance sheet?

Any amounts expended for work in process of completion at the time of closing the books should appear on the balance sheet as part of the inventory under the head of "work in process of completion." Any payments received on account of same should be deducted from this unless the payments received exceed the amounts expended on the work, in which case the amount received on account should appear as a liability under the head of "payment received on account of uncompleted contract,"

and the amount actually expended on the work be deducted therefrom as "less expenditure on same."

IX. In an audit of the books of a company, how may the correctness of the following items in the balance sheet be determined: (*a*) outstanding accounts, (*b*) securities, (*c*) inventory of finished stock and raw materials, (*d*) bank balances, (*e*) creditors' open accounts, (*f*) creditors' bills payable?

(*a*) Outstanding accounts—by examination of each account to see that it is "good," or if doubtful, that provision has been made for same under the head of "reserve for doubtful accounts." Where possible the correctness may be further confirmed by the auditor personally mailing a statement to each customer requesting verification of same to be sent to his own office. Discounts should also be provided for.

(*b*) Securities should be all produced at the same time, examined, listed, and compared with market prices, cost bills, etc.

(*c*) Inventory of finished stock and raw material should be checked as to extensions and footings and signed by the parties who made up the inventory. Raw material should be taken at cost if same be below market value; if above, at market value.

(*d*) Bank balances should be tested by having passbooks written up, checks compared with stubs of checkbooks, and outstanding checks deducted from the passbook balances.

(*e*) With regard to creditors' open accounts the balances should be compared with statements rendered, which the auditor should request to be sent to his own office. The stock-book should be carefully examined

to see that all goods taken into stock and appearing on the inventory have been actually credited on the books to the parties from whom purchased.

(f) Creditors' bills payable—the amounts should be compared with the stubs of the bill-book and the entries in the notes payable book. Where the notes given are numbered consecutively, the former is a most invaluable check; but where loose blanks are used the customer must fall back on the statement check for absolute confirmation of the accuracy of the amount, as there is nothing to prevent a note being given to a creditor and his account being left still open.

X. A company has caused to be made a revaluation of its buildings, plant and machinery, and it is found that the new values are greater than those shown by the books; what does this larger value indicate, and how should such excess be treated in the books of the company? What entries should be made to give effect to these conditions in (*a*) the balance sheet, (*b*) the profit and loss account?

The larger value would indicate either that items had been charged to the revenue account instead of being capitalized, or that an excess amount had been written off for depreciation.

The excess value should be charged to buildings, plant and machinery account and credited to a "reserve for depreciation account."

(*a*) In the balance sheet the excess should be added to the old valuation and the reserve account would appear on the liability side.

(*b*) It would be undesirable that the item should ap-

pear in the profit and loss account, as an abnormal increase in profit would be shown.

XI. A manufacturing corporation desires a certificate of its average annual profits for three years; after charging up all costs, expenses and depreciation, and an allowance for bad debts, it is found that the profits for the first year were $62,000, for the second year $64,000 plus $10,500 profit on sale of investments, and for the third year $72,000 plus $8,400 profit on the sale of real estate. Give the annual average profit to be certified.

$62,000 + $64,000 + $72,000 = $198,000 = total profit; $198,000 ÷ 3 = $66,000, the annual profit to be certified. The profits on sale of investments and real estate are abnormal for a manufacturing company; and while they are profits of the company they are not manufacturing profits.

XII. In some kinds of business the expenditure on repairs and renewals account varies considerably from year to year; how should this expenditure be dealt with in the books of the company so that the profits need not fluctuate by reason of this variable expenditure?

The expenditure should be provided for by charging profit and loss account and crediting "reserve for depreciation" account with such an amount annually as would be about the average (taking several years) amount expended for repairs and renewals. Then, as the expenditure was made, it could be charged against this reserve.

XIII. In an audit of the books of a company it is found that the president's salary account is credited with

a bonus of $5,000 for "extra services," in addition to the usual salary paid him; what steps should be taken to ascertain that this item is correct?

As such a bonus would have to be granted by the officers of the company, the minute book should be examined by the auditor to see that the amount was authorized by a resolution duly recorded. Should such a resolution not appear, it would be his duty to notify the directors, and, if the transaction were found correct, to ask them to have a resolution passed and recorded.

XIV. The profit and loss account of a manufacturing company, for six months ending June 30, 1896, contains on the debit side (*a*) stock on hand January 1, 1896, (*b*) purchases of raw material, (*c*) manufacturing expenses, (*d*) expenses of selling; on the credit side (*e*) sales, (*f*) stock on hand June 30. Does the balance of these amounts constitute the net profit for the six months, or should other charges be taken into account? If so, state them.

The balance of these amounts does not constitute the net profits, as the following charges should be taken into account:

Reserve for Bad Debts.
Reserve for Discounts.
Bad Debts.
Depreciation.
Repairs and Renewals, etc., etc.

XV. An audit of a set of books for the half year ending December 31 is begun January 26; what course should be pursued to prove the correctness of the cash on hand December 31?

The cash-book should be balanced, the pass-book written up to January 26, and a reconciliation account drafted as of that date. Then checking backwards to December 31, the balance may be verified on that date also. The method to be adopted is fully explained in the answer to question No. 3, December, 1896.

June, 1898.

I. State as briefly as possible the duties of an auditor of an ordinary manufacturing concern.

He should call for the production of all the books of account, list them, put distinguishing labels on them, and take down the name of the clerk in charge of each. As in every other kind of audit, he should check all cash transactions exhaustively, check the footings and postings of all books of original entry, and verify the correctness of all trial balances previous to the closing of the books. He should go over the inventories carefully and see that raw material and supplies are valued at or below current market prices, and where cost accounts are kept, it would be well for him to reconcile consumption and inventory at close with inventory at beginning of period under review plus subsequent purchases. The pay-rolls should next receive attention. Finally, the "closing entries" should be scrutinized carefully with a view to seeing that all income and expenditure properly applicable to the period under review was included in the revenue account, and that the Balance Sheet set forth fairly and truly the position of the concern.

II. How should the following assets be valued for the purpose of showing the true net capital of the partners in a private concern: (*a*) finished goods on hand, (*b*) raw material, (*c*) work in progress, (*d*) accounts receivable, (*e*) stocks and shares in other companies?

(*a*) Finished goods on hand should be valued at cost—i. e., cost of raw material, labor, and proportion of manufacturing expenses.

(*b*) Raw material should be valued at cost price, unless same be above current market price, in which case it should be valued at market price.

(*c*) Work in progress should be valued at a rate commensurate with the stage of completion at which it has arrived—amount of labor, raw material, supplies, superintendence, etc., actually expended on it.

(*d*) Accounts receivable should be valued as per ledger balances—with deductions—in the shape of adequate reserves for bad debts, discounts, etc.

(*e*) Stocks and shares in other companies should be taken at cost, due care being exercised to see that same does not exceed fair market value.

III. In making an audit what method should be adopted to guard against a second production of vouchers?

Each voucher should either be stamped or initialed by the auditor with colored ink on such a prominent and material part of the voucher as would render its reproduction without instant detection impossible.

IV. How should doubtful debts be treated in a balance sheet? Give a convenient method of ascertaining whether accounts receivable are good, bad or doubtful.

The ordinary method is to put down the total amount of accounts receivable and deduct therefrom the amount reserved for doubtful debts which has been previously charged off in the revenue account, and which appears

in a separate account as "reserve for bad and doubtful debts."

The most convenient method of ascertaining whether accounts receivable are good, bad or doubtful is for the auditor to have the total balances entered in a three-column sheet and to ask the manager or some responsible official who is familiar with the accounts to go over the ledger accounts with him seriatim. Accounts held to be bad or doubtful should be extended into the second and third columns respectively. All bad accounts should be charged off, and a liberal percentage charged to profit and loss account and credited to "reserve for doubtful debts" account. If an account is outlawed by the statute of limitations, it should be classed as bad. Where firms are in the hands of a receiver, the amount ultimately to be received is problematical, and the account should go into the doubtful column. No old unsettled balances should be accepted as good if more recent bills have been paid unless a satisfactory explanation is forthcoming. The auditor should see that the balances actually consist of specific charges, and are not composed of perhaps a series of disputed balances. Particular attention should be devoted to accounts where notes have not been paid at maturity and have been recharged to the customer. N. B.—For this reason, whenever a note is renewed, the transaction should always appear in the customer's account and not, as is frequently the case, simply consist of a transfer in the bills receivable account.

V. How should leases be treated in the balance sheet and in the profit and loss account of a company?

Where a lease of property has been purchased, the amount paid for same should appear on the balance sheet as an asset, under the head of "cost of leasehold premises." This should be written off in proportionate amounts to profit and loss account annually, so that expiration of value will coincide with expiration of lease.

VI. State which of the following should be charged to capital account and which to revenue account: (*a*) repairs to machinery and plant, (*b*) replacements of plant, (*c*) new plant purchased, (*d*) cost of leasehold premises, (*e*) partners' salaries.

(*a*) Repairs to machinery and plant—revenue account.

(*b*) Replacements of plant—capital account less residual value of that taken out.

(*c*) New plant purchased—capital account.

(*d*) Cost of leasehold premises—capital account.

(*e*) Partners' salaries—revenue account.

VII. A manufacturing company takes out and sells a quantity of old machinery and replaces it by new; what account should be credited with the proceeds of the sale? Give reasons.

Plant and machinery account should be credited with the proceeds of the sale, as the new machinery should be charged up at cost. If the proceeds do not equal the amount at which the old machinery stands on the books, charge off the difference to revenue account.

VIII. Differentiate as fully as possible a manufacturing account, a trading account and a profit and loss account, and state what the balance in each indicates.

A manufacturing account is designed to show the actual cost of goods manufactured during a certain period, and the balance shows cost of output.

A trading account should show the actual profit or loss on goods sold—difference between cost of acquisition or manufacture, with incidental expenses, and sale price. The balance shows the profit or loss on the transactions.

A profit and loss account is designed to show the net profit or loss of a business for a certain period, after all items of income and expenditure have been taken into account. The balance shows the amount of increase or decrease of capital or surplus resulting therefrom.

IX. How should the loss on shares issued at a discount be dealt with in the accounts of a corporation?

The loss on shares so issued should be charged to "discount on shares issued" account and be gradually wiped out by periodic proportionate charges to revenue account.

X. In examining the books and accounts of a business for the purpose of giving a certificate of the net profits earned for a number of years, how should interest paid on partners' capital be treated? What other important points should receive attention in order to state the profits net?

Inasmuch as such charges would have the effect of decreasing the amount of net profits shown, it would appear desirable to eliminate these items from the profit and loss account and show the net earnings separately.

If large amounts had been paid from time to time as interest on loans, bills payable, accounts payable, etc.,

the same principle would apply, as this would show a deficiency of working capital. With sufficient capital these charges would not be incurred, and the net earnings would consequently be increased by these amounts. On the other hand, it would be most necessary to see that adequate amounts had been periodically written off for depreciation, and that provision had been made for reserve for discounts, bad debts, etc. All items of capital expenditure would require to be carefully examined to see that no amounts properly chargeable against revenue had been included therein.

XI. How may the auditor know that the balance sheet and profit and loss account of a corporation whose books he has audited include all income and expenditures applicable to the year under review?

With regard to the profit and loss account, the auditor should see that the closing entries have been properly made of those items which appear upon the books—i. e., that the balances of the nominal accounts are correctly transferred. He must then be guided by his experience to ascertain what items of income and expenditure not appearing upon the books should be taken into account. These will necessarily vary according to the particular nature of different kinds of business. Such matters as depreciation, reserves for bad debts and discounts would have to be taken into account, as would all accrued liabilities such as interest, wages, etc. On the other hand, prepaid charges such as rent, unexpired insurance, interest earned but not collected should be taken credit for. The accuracy of the result arrived at in the profit and loss account should be confirmed by the balance

sheet, such confirmation being prima facie evidence that the balance sheet is full and correct.

XII. In a large dry goods business it is considered necessary to divide the bookkeeping in such a way that each ledger shall be balanced separately; how should this be done?

The ledgers should be planned as follows:

(1) A general ledger to contain the nominal and real accounts with separate "controlling" accounts for purchase and sales ledgers, thus containing all the materials for a complete independent trial balance, the controlling accounts showing the totals of the amounts due by customers and due to creditors.

(2) A purchase ledger containing individual accounts with creditors and a "general ledger account" which should show a debit balance equal to the total amount of credit balances in the ledger and agreeing with the controlling account in the general ledger.

(3) As many sales ledgers as may be deemed desirable, divided up to contain customers' accounts in alphabetical order, A-F, G-I, etc., and each containing a "general ledger account," the total credit balance appearing in which is equal to the total debit balances appearing in it, agreeing, of course, with the controlling account in the general ledger. The cash-book, sales-books, journals, etc., should contain separate columns for each ledger, the totals of which are posted periodically to the several controlling accounts in the general ledger and to the several general ledger accounts in the purchase and sales ledgers. In some cases, instead of separate columns for separate ledgers in sales-books, journals, etc., it may be

found more convenient to use separate books of entry. Each ledger can now be balanced separately. The total sales charged in any particular ledger are at the end of the month to be credited to its general ledger account, the total cash credits to customers debited, and thus the accuracy of the posting into each ledger separately demonstrated.

XIII. Is a trial balance the same as a balance sheet? If not, in what way does it differ?

It is not.

The trial balance contains the balances of all the ledger accounts, nominal, real, and personal; while the balance sheet contains only a list of resources and liabilities in condensed form made up from the trial balance after the closing entries have been made. A trial balance made up after the closing entries have been made contains the balance sheet items in extended form.

XIV. A partnership contract between A and B provides that each partner shall contribute $25,000 to a new business, and that on any capital brought in by either partner in excess of this amount he shall receive 6%. A contributes $10,000 additional, and the bookkeeper makes an entry in the books at the end of the year crediting A with 6% on $10,000, viz., $600, which is debited to B. Is this correct? Give reasons?

It is incorrect. A should have been credited and B debited with $300, as the whole of the capital contributed is $60,000, of which A should contribute half—i.e, $30,000. To preserve this proportion he (in theory) can only lend B $5,000, on which sum he is entitled to 6% interest, viz., $300.

XV. What course should be adopted in an audit of the books of a firm where defalcations are suspected?

The auditor should first ascertain by examination and inquiry the most likely sources of leakage and act accordingly. He should count the cash on hand, deposit it in the bank, have the pass-book written up, and reconcile its balance with that of the check-book and cash-book. He should then carefully check the footings of the cash-book, as most defalcations where cash has been appropriated are covered by intentional false footings and making corresponding intentional errors of addition in some ledger account. All ledger footings should be checked, and cash items checked from the ledger into the cash-book. Where a columnar cash-book is in use, particular attention should be paid to see that items are entered in the proper columns, and that vouchers are forthcoming for all amounts appearing in the "expense" column, Returned merchandise book should be scrutinized and all items verified, as false entries may be made to cover cash appropriations. Finally, statements should be mailed personally by the auditor to all customers and creditors with a request that they be examined and returned to his own office noted as correct or otherwise. This is a matter where experience is the best teacher. The auditor would have to be guided by the circumstances of the case, relying upon his own tact and judgment as to the best methods to pursue.

December, 1898.

I. What is an *auditor?* What qualifications must he possess? What are the objects to be attained by an audit?

An auditor is an accountant who passes in review the work of others to ascertain its correctness in regard to the record of financial transactions in books of account to enable him to certify to a statement of his client's affairs upon a certain given date.

The auditor should possess a thorough knowledge of every branch of bookkeeping, and corporation and commercial law. He should have as complete an acquaintance as possible with the general methods and principles upon which various particular businesses are conducted.

He should possess a liberal education, tact, firmness, courage, an even temper, patience, good judgment and reliability. The last qualification is by no means of the least value, for it is well for the auditor to be known as "a safe man."

The objects to be attained by an audit are briefly the detection of

Fraud,
Technical errors,
Errors of principle.

II. State briefly the duties of an auditor of a corporation?

The duties of an auditor of a corporation are to make a complete examination of all the books of accounts, to

see that all charges and credits in the profit and loss account are correct and proper, and, finally, that the Balance Sheet exhibits the exact state of the corporation's affairs as of the date he is called to certify.

He should carefully examine the minute book to see that the remuneration paid to officers of the corporation has been authorized, and to ascertain that dividends (if declared) have been passed on by the directors.

He should see that if dividends have been declared they have been earned, paid out of surplus earnings, and not work an impairment of capital. The stock ledger should be examined to see that it is properly written up, and that the amount of stock issued does not exceed the amount of the authorized capital stock of the corporation.

The examination of the books of account would (bearing in mind these points) be conducted in precisely the same manner as those of an individual or co-partnership.

III. What is the significance of an auditor's certificate of profits of a business about to be sold to a new company? To what extent is an auditor responsible, morally and legally, for his certificates?

The significance of the auditor's certificate is that he is able, after exhaustive examination of the books of accounts, to give an assurance that the earnings are correctly stated, and that the assets and liabilities are neither under nor overstated. To enable him to do this conscientiously, he must previously have ascertained that the percentage of gross profit was constant; that the revenue account had been periodically charged with a proper percentage of cost of plant, machinery, etc., for

depreciation; that all extraordinary profits were shown separately, and that interest on loans, partners' salaries, etc., were not overlooked. The final significance is this: That the balance sheet, which he brings before the responsible officials of the purchasing company, containing the net result, is in such a form that they thmeselves can exercise their judgment upon it.

As to the responsibility of an auditor morally, from an ideal standpoint, he should be held liable for any error of omission or commission which might subsequently appear, which he had either intentionally or unintentionally overlooked; but, legally, it is questionable if he could be held responsible for anything less that intentional certification to a fraudulent representation of facts, resulting in pecuniary loss to those induced to part with their money, relying upon his certificate.

IV. State what an auditor should do to ascertain if the following assets, appearing in a balance sheet, are taken at a fair value: (*a*)merchandise, (*b*) machinery, (*c*) real estate.

(*a*) Merchandise: Its value should be determined by comparing inventory with stock-book and purchase bills. If the cost price is equal to or below the current market price, it should be taken as the fair value of the merchandise; but if the cost price is above the market price, then the inventory should be taken at current market value.

(*b*) Machinery: The value should be determined by comparing purchase bills with ledger entries, care being taken to see that no repairs were added to the ledger account, and to ascertain that a proper percentage for

depreciation had been periodically deducted from the cost price. When original invoices of cost are not producible, the services of a competent appraiser should be invoked, whose valuation should be accepted as correct.

(*c*) Real Estate: The purchase price should here be taken plus any expenditure for improvements. Where a sale is contemplated, a professional appraiser should be employed; but where it is held as a business capital investment for use, the purchase price should obtain: any increment in value being regarded as a secret reserve.

V. State what means should be employed to ascertain if the following assets were properly included in a balance sheet at the valuation given: (*a*) stocks and bonds, (*b*) bills receivable, (*c*) accounts receivable.

(*a*) Stocks and Bonds: These should be first examined, counted and listed. Those quoted on the Stock Exchange can be put down at current market value; those not, at valuation obtained by inquiry, trade reports, etc.

(*b*) Bills Receivable: These should be taken at face value, and should either be on hand or left at the bank for collection. Those on hand should be examined to see that none are overdue, and listed; those at the bank should be evidenced by a certificate from the bank as to number and amount. The question of makers and indorsers is important, and in certain cases reference would have to be had to rating lists, etc. Of course, no overdue bills should be allowed to be included.

(*c*) Accounts Receivable: To determine their value it would be necessary to examine each account to see that none were outlawed, considerably overdue, bad, or doubt-

ful, in the usual manner, and care exercised to see that adequate provision had been made for bad and doubtful debts, discounts, etc.

VI. What measures should be taken by an auditor to satisfy himself that all liabilities had been brought into the books and balance sheet of a manufacturing business?

The question is, What would be the liabilities which one would naturally expect to find in the balance sheet of a manufacturing company? Bills and accounts payable, interest accrued, wages accrued and unpaid, taxes, contingent liability on notes discounted and uncompleted contracts would probably be those which would readily occur to the auditor, and he would have to determine by inquiry and examination if there were others.

As to bills and accounts payable, an examination of the books, and requests for statements from creditors would enable the auditor to determine the amount which should appear in the balance sheet.

Should the percentage of gross profit appear to be abnormally large, he might be justified in suspecting that goods had been taken into stock, appeared upon the inventory, but had not been passed through the books to the credit of the sellers. On the other hand, he might develop by examination the fact that large quantities of goods had been returned by purchasers, taken into stock and not passed through to the credit of the purchasers.

As to interest accrued, an examination of the bill-book would enable him to figure out what was accrued at the date of the balance sheet.

Wages accrued could be ascertained from the pay-roll

book, or a very close estimate made by comparison with the preceding week.

Taxes: These could be ascertained by inquiry or by reference to the book records of previous years.

Contingent liability on notes discounted could be figured by reference to the bill-book.

Lord Davey's words may be appropriately quoted here: "The auditor is bound to know everything the books tell him, to have all the suspicions that the books suggest, and to make all the inferences to what he finds in the books would lead him."

VII. How may an auditor know that credits for merchandise returned are *bona fide*, and not made to conceal a shortage in cash?

This depends materially upon the system of internal check. If the system be thorough and the auditor is satisfied that there is no collusion between the cashier and the credit clerk, he can readily determine that the merchandise credits are *bona fide* by reference to shipping-inwards book, correspondence, etc.. But where collusion is suspected, and this would probably involve cashier, credit clerk and stock clerk, then it would be necessary to send statements to customers for verification. Were these irregularities very extensive, the result would be shown in the gross profit of the merchandise account, but occasional false entries would be very difficult to detect. The auditor should check *from* the ledger to the cash-book all moneys received, and he might find entries credited as cash which were not in the cash-book, but in the credit book. This would be prima facie evidence of a shortage in cash, which could be absolutely determined

by reference to the party in whose account the entry appeared.

This is similar to fraud in pay-rolls. A good system will render its perpetration exceedingly difficult and its exposure simple; while its dicovery later on is a matter of great difficulty.

VIII. What classes of salaries and wages should be charged directly against the cost of manufacture? Give reasons.

Against the cost of manufacture should be charged wages of workmen actually employed in the manufacturing, of superintendent of factory (because this is a direct addition to the cost of labor), of those connected with the management of the light, heat and power (because the work could not be carried on without them), and of all the foremen. In short, any wages paid for work done in any way connected with actual manufacturing should be charged directly against the cost of manufacture.

IX. How should the right to remuneration claimed by officers and directors of a corporation be verified?

The right to remuneration should be verified by reference to the minute book of the corporation, which should contain resolutions authorizing the payment of the amounts claimed.

X. How should the bank balance appearing in the books of a company be verified by the auditor?

Supposing that the auditor has started on his work before the books are closed, at the close of business on

the last day of the fiscal period under review, he should balance and rule off the cash book, count cash and checks on hand, and see that they, added to the check-book balance, agree with the balance called for by the cash-book. He should then personally deposit these checks and cash in the bank, and request that the pass-book be written up and returned to him at his own office. When he receives it he should make up a reconciliation account by adding all checks entered in the cash-book not returned by the bank to the check-book balance as of the date of closing the books, and the total should agree with that shown by the pass-book. But should he commence his audit at some date subsequent to the closing of the books, then he should proceed in the manner indicated in the answer to question number three, December, 1896.

XI. To what should the discount on bonds sold for construction and the expense of disposing of such bonds be charged? Give reasons.

The discount on bonds sold for construction and the expense of disposing of such bonds should be charged to construction account. The reason is that the construction work has cost not only the amount actually expended thereon, but the discount on and expenses of disposition of the bonds also.

XII. Under what circumstances should paid checks be treated as vouchers? Are checks proper and sufficient vouchers for purchases? Give reasons.

Checks may be treated as vouchers when the purpose of the payment is stated on the face of the check, the

endorsement of payee then becoming a receipt of a specific sum for a specific purpose. There are cases when the auditor may accept a check as a voucher without this; but he should be fully conversant with all the facts of the transaction, and have satisfactory evidence that the payments were duly authorized.

As a general rule, checks are not sufficient vouchers for purchases, because they only specify the payment and receipt of an amount, but not the purpose, or at all events, the particular items, which the check covers.

XIII. What books of a corporation, in addition to the ordinary trade books, should be inspected by the auditor? Why?

In addition to the ordinary trade-books, the auditor should inspect the minute book, to ascertain if the making of specific contracts was authorized, to determine the remunerations of officers, and, in short, to see that all acts of the corporation were "intra vires." He should next examine the transfer book to see that it is in order, the stock certificate book and the stock ledger to see that the latter is written up to date; that the issue of the amount of authorized capital stock is not exceeded, and that it agrees with the amount shown on the financial books.

XIV. In auditing the books of a company for the first time after a reorganization, what should an auditor do to verify the opening entries? Give reasons.

He should carefully examine the minute book to ascertain what contracts were entered into and the terms under which the re-organization was effected. He should ascertain on what terms the old liabilities were setled or

taken over, what additional assets (if any) were acquired, and what agreements were made as to the issuing and disposing of new stock. He should see that all assets and liabilities were properly brought on to the books of account, verify the opening entries by comparison with the information which he has thus elicited, and finally, by actual test, assure himself that all the conditions of the law in regard to the accounts have been duly complied with.

XV. How may the auditor ascertain the profits for a given period, from the books of a company kept on a system of single entry?

In single entry the profit or loss for a given period is determined by what is termed the "Resource and Liability" method, which consists in comparing all the assets at the end of the period under review with the liabilities (including capital accounts); the excess of the assets over the liabilities constitutes the net profit. The confirmation of the accuracy of the result by the same figures being arrived at by means of a profit and loss account is, of course, lacking. All cash transactions would have to be most carefully gone over, footings and postings of cash work checked, and balance verified. The sales and purchase books should be footed and the footings checked. Finally, the balances of all the personal accounts should be extracted from the ledger and the several schedules of assets and liabilities constructed, which are the component elements from which the Resource and Liability statement is made up.

June, 1899.

I. Define *audit, auditor.*

Audit:—(Latin—audit—he hears). The examination of an account by a person appointed to tests its accuracy, by comparing each item with vouchers, adding up each page, and at last authoritatively stating the sum owing or at credit. The term is used by Shakespeare:

> "Yet I can make my *audit* up. . . ."
>
> —Coriolanus, I., 1.
>
> "To keep your earthly audit." . . .
>
> King Henry VIII, III. 2.
>
> "And how his *audit* stands. . . ."
>
> —Hamlet, III., 3.

An old writer, Ayliffe, in his "Parergon" writes: "Bishops' ordinaries, *auditing* all accounts, take twelve pence."

Another, Arbuthnot, says: "I love exact dealing, and let Hocus *audit;* he knows how the money was disbursed."

Auditor: (Latin—auditor—a hearer)—A person appointed to examine accounts.

Shakespeare writes:

> "If you suspect my husbandry, or falsehood
> Call me before the strictest *auditors,*
> And get me on the proof."
>
> —Timon of Athens, II., 2.

II. Is it the duty of an auditor of a bank actually to inspect the securities representing the bank's investments? If so, what course should be adopted in conducting such examination?

It is. The auditor should call for the actual production of the securities simultaneously, examine and list them, and compare them with (as to value) current market quotations. The result arrived at will weigh with him in determining the figure at which they should stand in the balance sheet, to the accuracy of which he is asked to certify.

III. In the event of such a difference of opinion between auditor and directors concerning the rate of depreciation on plant and machinery as would involve an important alteration in the proposed rate of dividend, how can the matter be settled to the satisfaction of both parties?

The matter might be settled to the satisfaction of the auditor by agreeing to call in the services of an expert appraiser, and to be bound by his decision. But should such appraiser confirm the auditor's views, and the depreciation to be written off necessitated a reduction in the proposed rate of dividend, it is questionable what degree of satisfaction the directors would derive!

IV. Is it a part of the duties of the auditor of the accounts of a stock company to consider the question of depreciation on assets, such as buildings, machinery, plant, etc.? Give reasons for your answer.

Yes; it is a most essential part of his duties. All assets subject to wear and tear in course of time have to be replaced. If provision is not made for this out of

the earnings of the company, by writing off to profit and loss account periodically such a percentage of cost as will make expiration of value synchronous with residual value, then the installation of new plant, machinery, etc., would have to be made by the introduction of fresh capital; as presumably that portion of the earnings which should properly have been set aside for the purpose would have been distributed to the stockholders in the form of dividends.

V. In examining cash vouchers in the course of an audit, is it necessary to place your initials or some other distinctive mark on each, and if so, why?

It is.

Because such mark would prevent the imposition on the auditor of the same voucher for two distinct payments.

VI. If the cash in hand of a firm or company under audit consists in part of checks received from customers but not deposited in bank, how may the auditor assure himself that such checks are properly included?

The auditor should compare the checks with the amounts and names entered in the cash-book *prior* to the date of balancing and closing same to ascertain that they form a *bona fide* part of the balance of cash on hand at that date.

VII. Show how the bank transactions of a partnership or company under audit may be utilized in verifying the cash-book.

If the principle of depositing in the bank *all* moneys received is followed, the total deposits, as per pass-book, will agree with the total receipts entered in the cash-book. If all payments be made by check (except petty cash disbursements), the total charges in the cash-book should agree with the total footing of the check-book stubs. The deposits, if entered on the check-book as made, can be verified as to *date* and amount with the entries in the pass-book. The check stubs can be compared with cash-book entries, and by means of a reconciliation account the pass-book balance can be made to serve as a test of the accuracy of the cash-book balance. The disposition of notes receivable can be traced, as can also that of drafts, etc.

VIII. What is the value of a bank pass-book for the purposes of an audit? To what extent should it be taken as a voucher for cash-book entries, or for the balance carried forward?

Its value consists in the fact that the auditor can satisfy himself of the actual existence in the bank of a certain sum at certain given date, and that the amounts and dates of all deposits can be verified.

The pass-book (the auditor having taken the precaution to ascertain that he is in possession of the genuine one) may be taken as a voucher for the receipt by the bank of moneys deposited, and for the balance carried forward in the cash-book, after he has reconciled said balance with the pass-book balance in the usual manner.

IX. Is there any satisfactory method of auditing accounts not kept by double entry? If so, illustrate the method.

There is.

The auditor should check all receipts and payments—into the bank by the pass-book, and out—through the check-book, reconciling the pass-book balance with the check-book balance in the usual manner. All the footings of and postings from the cash-book should be checked, the check-book stubs compared with the cash-book entries, and same vouched as completely as possible. The footings and postings of all books of original entry should be checked, the inventory gone carefully over, and the existence of all other than book assets and the valuation of same proved from the given data and all possible sources. The profit or loss should be arrived at by comparing the assets with the liabilities. Although the nominal accounts and controlling accounts are not kept in single entry books, the auditor is often able to construct them; and, where possible, this should always be done. The effectiveness of the audit will depend materially—much more so than in double entry books—upon the closeness and care with which the checking is performed.

X. In auditing the accounts of a private firm where there are several partners, to what points should the auditor look in order to be assured that the partners' accounts are correctly stated in the balance sheet?

He should procure a copy of the co-partnership articles of agreement and thoroughly familiarize himself

with its provisions. In this connection his duty would be to see that they are carried out in the bookkeeping.

The principal points to which he should give attention are:

I. To see that each partner has actually contributed the amount of capital agreed to.

II. That all partners are charged with interest on withdrawals and credited with interest on investment of capital, if so agreed.

III. That no partner has withdrawn more than was stipulated.

IV. That any agreement as to interest on excess capital brought in by any partner has been complied with.

V. That no items properly chargeable to individual partners have been charged to the firm.

VI. And, lastly, that profit or loss has been credited or charged to individual partners in the proportion provided for in the copartnership articles of agreement.

XI. What evidence should an auditor require as to the existence of assets (other than book debts) appearing in a balance sheet, and as to the correctness of the amounts as entered in the books?

I. Cash—by actual count of cash undeposited, and bank balance by comparison of cash-book balance with check book balance by means of a reconciliation account.

II. Notes receivable—by actual inspection if on hand; if at bank for collection by procuring a certificate from the bank of the amounts and other particulars of notes in their possession.

III. Plant and machinery—by actual inspection, by comparison of invoices with ledger accounts, seeing that

no repairs and renewals expenditure is entered therein, and by seeing that the amount has been periodically written down by charges to profit and loss account for depreciation.

IV. Buildings—by receipted purchase bills, and by the production of title deeds, etc.

V. Investments—by the production of the securities and by comparing same with market values, etc.

VI. Inventory—by securing the signatures of the parties who wrote it; by checking the extensions and footings of the same; by the percentage test through the manufacturing or trading account; by comparison with market prices current on the principle of "cost or market whichever is lowest"; and by seeing that all items appearing therein have been credited on the books to the parties from whom purchased, or, in the case of return sales, to the parties who returned the goods.

VII. Prepaid charges—such as insurance, rent, etc.—by the inspection of the policies, receipts for rent, etc.

XII. State generally your views as to what constitutes capital expenditure and expenditure properly chargeable against revenue. Under what circumstances would an auditor be justified in refusing his certificate of audit?

Capital expenditure is the replacement of one form of an asset by another, or the enhancement in value of an existing one by additional expenditures.

Revenue expenditure does not create an asset, but is incurred with the object of earning a revenue. This is the broad, general distinction between the two classes. It is in the power and ability to distinguish between

them and classify expenditure accordingly that one of the chief values of an auditor consists.

An auditor would be justified in refusing his certificate of audit (1) should revenue expenditure be found to have been capitalized, and should his proposal to properly adjust same be refused; (2) should the officers and directors of a corporation refuse him permission to provide adequate reserve for depreciation; and (3) should dividends have been paid where no surplus existed against which to charge them.

XIII. An auditor has to audit the accounts of a firm or company which is a large employer of labor, fixed and extra; state (*a*) what vouchers the auditor should expect to find, and, in the case of the extra labor, how such vouchers should be certified, (*b*) what course the auditor should recommend his client to adopt to make sure that there were no "dead men" charged on the fixed lists.

The auditor should (in the case of fixed labor) expect to find as vouchers the pay-roll sheets or book signed by the clerk by whom it was made up, the foremen's certified time-books, and cancelled checks agreeing in amounts with the totals of the pay-rolls.

In the case of extra labor he should be furnished with separate pay-roll sheets, containing names and signatures of receipt by the payees, said sheets being also certified by the foreman, and by the manager or some responsible officer.

(*b*) To make sure that no "dead men" were charged on the fixed lists, the auditor should recommend that the actual payer of wages should occasionally be changed, and that either the manager or he (the auditor) person-

ally should occasionally put in an appearance while the wages were being paid out.

XIV. What reserves should the auditor expect to find set aside out of income, besides those for bad debts and discounts, in the case of (*a*) a steamship company, (*b*) a telegraph company?

(*a*) In the case of a steamship company, the auditor should expect to find reserves for

1. Repairs and renewals;
2. Casualties and other contingencies;
3. Insurance and pensions.

(*b*) In the case of a telegraph company:

1. Repairs and renewals;
2. Contingent legal expenses, etc.

XV. In what way may an auditor form an opinion as to the value of book debts and outstanding accounts generally?

He may form an opinion as to their value by examining carefully, in the company of some responsible employee or member of the firm each outstanding account, so as to ascertain that the balances are made up of specific bills unpaid, that no old disputed portions of bills are included, that the balance is of comparatively recent date, not outlawed by time expiration, by reference to trade ratings books, and by seeing that provision has ben made, in the form of reserves, for doubtful debts, discounts, etc.

January, 1900.

I. When an auditor employed to adjust the accounts of a firm finds that the current work is behind and that no trial balance has been made for over a year, what course should he pursue, having regard for his own interests as well as for those of the firm?

He should make an exhaustive cash audit, construct controlling accounts so as to be able to make up a balance sheet, and by completing the posting of all charges and credits to the nominal accounts, obtain the material to construct a profit and loss account to confirm the accuracy of the result of the year's operations shown on the balance sheet. While this is being done he should employ extra assistants to aid the office staff in bringing the work up to date and in taking off a trial balance as of the last day of the period under review. He could then proceed with his audit of the whole period in the usual manner.

II. What books and other sources of information should an auditor require in connection with the first audit for a corporation?

He should require a copy of the articles of incorporation, a copy of the by-laws, the minute book, stock certificate book, transfer book and stock ledger. In addition to these, he should call for the production of the cash-book, journal, sales-books, purchase books, returns books (sales and purchases), ledger and trial balance

book. He would also need all vouchers, returned checks, check-books and pass-books; in short, all the financial and subsidiary books in any way recording transacations of the corporation.

III. How should an auditor verify the correctness of the several accounts receivable found open on the books of a mercantile firm whose accounts he is called on to audit? Give reasons.

All charges should be checked from the sales-book or copy-book containing fac-simile of bills rendered. Cash credits should be checked into the cash-book, and credits for goods returned into the return book and stock-book. Discounts credited should be checked into the cash-book or journal, and notes credited should be compared with the bills receivable book and cash-book. He should check the footings of each account and compare the balances disclosed with the monthly balances entered in the trial balance book. When irregularities are suspected, a final test could be made by the auditor personally mailing statements to the customers requesting that they be returned to him at his office approved as correct. The reasons are that he may satisfy himself that all cash received in settlement of charges has been accounted for, and that no accounts standing open as unpaid have been paid and the cash abstracted by a dishonest employee.

IV. How should the auditor treat a company's accounts with its several agencies at the end of the fiscal year, each agency having been charged with all of the goods shipped to it, and each having some stock remaining on hand?

The treatment would depend materially upon the system on which the accounts were kept. Supposing that a separate merchandise account was kept for each agency on the books at the main office, each agency would be charged with goods shipped, credited with sales as reported monthly and with inventory on hand at the end of a fiscal period. If an agency sales ledger controlling account be kept, goods sold would be charged to it, and cash as received credited; the balance would show amount outstanding. A cash account would show cash remitted to the agency and received from it as accounts are collected, or credited if for expenses reported. An expense account for each agency would show the cost of running the agencies, and thus the profit or loss on each agency ascertained. At the end of the fiscal year, on the main office balance sheet, the amount of the cash in agents' hands, inventories and accounts receivable would form separate items among the assets, it being made clear that these items were in the hands of agents and not at the main office.

V. If you were called in to investigate the books of account of a manufacturing firm that contemplated selling its business to a corporation, and were required to report on the net profits of the past five years, what would be your course? How would you ascertain the value of the plant and machinery, and of other assets that might affect the net profits of the period under review? Give an indication of the report you would make.

I should make a thorough and exhaustive examination of the trading account to ascertain that the percentage of gross profit was fairly constant; that all purchases were

charged up as well as return sales; and the inventories had been correctly made up as to values and calculations.

Proceeding next to the profit and loss account, I would scrutinize each item appearing therein; see that there was no very great fluctuation in the net profits; that no profits of an extraordinary nature made on outside ventures were included; that proper charges had been made for depreciation; and that no expenditure properly chargeable therein had been capitalized. Having assured myself that the profit for each year was correctly stated, I should take the average annual result of the five years' trading as a basis of calculation.

I should ascertain the value of plant and machinery by comparing the purchase bills with the ledger entries; see that a proper percentage of depreciation had been periodically written off, and that no outlays for repairs were included therein. The same process would be followed in arriving at the values of buildings, etc.

Accounts receivable would have to be examined and scrutinized to test their value; bills receivable and securities produced, and all other assets subjected to review. The report made would depend upon circumstances, but in general might read after this fashion:

Dear Sir:

In accordance with your instructions, I have made an examination of the books and account of Messrs. So & So for the five years ending December 31, 1904, and beg to report that the average net annual earnings for the period were ———. Appended please find a statement

of assets and liabilities, to the correctness of which, as well as to the net earnings, above stated, I hereby certify. Yours faithfully, C. P. A.

VI. In making up the balance-sheet of a firm or corporation, how should the auditor treat goods that (*a*) have been sent abroad on consignment and remain unsold, (*b*) are in the hands of the agents at home, (*c*) have been sent out on "sale or return"?

(*a*) In making up the balance sheet, goods that have been sent abroad on consignment and remain unsold should appear under a separate descriptive heading as an asset—being part of the inventory—and there should always be a certain percentage deducted as a reserve for losses on same.

(*b*) Goods that are in the hands of agents at home should be treated in the same way.

(*c*) Goods sent out on "sale or return," should form part of the inventory, as they are simply "on memorandum."

VII. You are called in to examine the books of a firm whose bookkeeper and cashier has absconded. He is known to be an embezzler to the amount of at least $2,000. The books have been kept by double entry and are apparently correct. How would you proceed to determine the total amount of the embezzlement? Mention the different methods that the embezzler might have used to hide his stealings.

The cash on hand should be counted, and the pass-book written up and reconciled with check-book balance. The stubs of check book should be compared with the cash-

book entries and the deposits checked as to dates and amounts. The cash-book footings should be gone over and the postings checked. The books of original entry should be footed, the postings checked and the trial balances verified. Finally statements should be issued to each customer, with a request that they be examined and returned marked correct or otherwise.

To hide his stealings the embezzler might have

(1) Made false footings to the cash-book, appropriated the differences and made a corresponding false footing to some ledger account. This would keep his books in balance and bring out the cash balance apparently correct.

(2) He might intentionally transpose figures in taking forward the footings of the cash-book and cover it up by falsifying the ledger footings.

(3) He might omit to enter sales (cash or credit) and appropriate the collections.

(4) He might credit as return sales, amounts of cash received and take the cash.

(5) He might pocket the difference between actual discount allowed and a ficticious amount entered by himself in the discount column in the cash-book.

He might—the methods are endless! No known system will prevent theft, but an audit, properly conducted, will speedily lead to its detection and exposure.

VIII. In making up the annual balance-sheet of a manufacturing business, what values should be stated in the inventory of completed product on hand, product in process. and unconsumed materials, assuming that average conditions prevail with respect to market prices of material and labor?

Inventory of completed product on hand should be valued at cost of production; product in process to the extent to which it has approached completion; unconsumed materials at cost or market price, whichever is lower.

IX. Should the auditor of a firm or corporation revise the form and wording of the balance-sheet to which his certificate is to be attached? Give reasons.

Yes, if necessary. The assets and liabilities should be so stated and worded as to leave no doubt as to their meaning—even to the ordinary layman. The auditor should bear in mind the fact that he is acting, not in the interest of the directors and officers, but in that of the stock-holders and the general public, banks, etc., who rely upon his bona fides, to state clearly the exact position financially of a corporation as of a given date. The lumping together of such items as "capital and surplus," "profit and loss" should always be resisted as being utterly misleading.

X. Give reasons for or against the necessity of an auditor's verifying the stock ledger of a corporation.

It would appear desirable that the auditor should verify the stock-ledger to see that the amount of authorized capital stock is not exceeded. This ledger is easily made self-balancing by charging in a balance account the total amount of the capital stock and crediting individual stockholders with their holdings. This need only apply to the numbers of shares issued and held; and so that that agrees with the capital stock account in

the general ledger, the auditor need not trouble himself about further details.

XII. In balancing a set of books consisting of cash-book, purchase book, sales-book, journal and ledger, the debit side of the trial balance is found to be $87.19 in excess of the credit side; how should the error be sought?

Check the footings of all the books, add to the totals of the former trial balance the totals of all debit and credit entries since made and the result will be the correct footings of the new trial balance. The side on which the error is made will then be apparent and the checking over limited accordingly. This method presupposes that no accounts have been ruled off, and also that the total debit and credit footings of every account appears upon the trial balance. Many "devices" so-called are in use—but it will be generally found that "the longest way round is the shortest way home," and that after these devices have been tried and found wanting (as is most often the case), there is nothing like the good old-fashioned way of "calling over."

XII. Describe the steps necessary to make a complete audit of a savings-bank.

Cash on hand should be verified by actual count, all securities should be produced at the same time, listed and compared with market values; all other investments by satisfactory evidence as to cost and present value. The cash-book should be footed; deposits checked to depositors' accounts; interest checked as to calculation, credit to depositors, and charges to the income account.

Interest accrued at time of closing the books should be checked, and the total amount due depositors (after verification) compared with the general ledger controlling account. Where possible depositors' pass-books should be compared with ledger balances and accounts. The deposit slips and checks can be used to verify deposits and withdrawals. The income account should be carefully examined to test the propriety and sufficiency of the entries, and lastly the correctness of the balance sheet proved. Great care should be exercised to see that the methods employed in the conduct of the business are *intra vires,* and that all statutory provisions have been complied with.

XIII. Describe the processes of verifying the cash-book of a partnership or company by means of the bank transactions.

Proceeding on the assumption that all receipts are deposited in the bank and that all payments, except those made through the petty-cash are made by check—the auditor should see that the balance as per cash-book at the day of closing, agrees with the check-book balance, which should be reconciled with the pass-book balance, by deducting from it the amount of all checks not returned by the bank. Check-book stubs, should be compared with cash-book entries; deposits checked with the pass-book entries as to date and amount; and bills receivable collected at bank or discounted there, as well as notes payable, paid or discounted there, compared with pass-book entries and with the cash-book. In this way the monthly cash balances appearing in the cash-book and trial balances can be absolutely verified.

XIV. The YCX Co. takes a large number of notes (bills receivable) from its customers, and when in need of funds discounts or sells them; how may the accounts be managed so as to show the company's liability as indorser on the paper discounted?

All notes received in payment of accounts should be credited to the party from whom received and charged to Bills Receivable account through the journal. When notes are discounted or sold the cash received should be credited to a "Bills Receivable Contingent Liability" account. When paid, this account should be charged and Bill Receivable account credited through the journal. The credit balances of the Bills Receivable Contingent Liability account will then always show the amount of the company's liability as indorser on the paper discounted or sold. The same result might be obtained by the method suggested in the author's "Theory of Accounts."

XV. The machinery used by a firm has been purchased on the instalment plan, with monthly payments, and under the stipulation that the title shall pass only when the last payment has been made. At the close of the fiscal year there are yet several payments to be made. The firm also pays a royalty on the output of some of the machines secured on this plan. How should the auditor in his annual statement deal with the machinery, the instalments paid, and the royalty.

An account should be opened for "Machinery Account Special," and at the top of the ledger should be entered particulars of the price, dates and amount of installments to be paid. As each installment falls due, the account

should be debited and the vendors credited with the amount. The installments as paid would be charged through the cash-book to vendor. At the end of a fiscal period the machinery account would figure as an asset —"paid on account of machinery"—with a note stating amount necessary to complete the purchase.

The royalty due at time of closing should be charged to profit and loss account and credited to the parties to whom due. This would appear amongst the ordinary accounts payable.

June, 1900.

I. Explain generally the duties of an auditor. State the qualifications and training necessary to fit an auditor for the discharge of his duties.

The duties of an auditor are to pass in review the work of others, and to determine the correctness of accounts as evidenced by absence of fraud, technical errors, and errors of principle. Having ascertained that the accounts are correct, it is the auditor's duty to certify to the correctness of the earnings of the undertaking for a given period, and of the balance sheet as of a given moment of time.

To fit an auditor for the discharge of his duties he should possess a thorough knowledge of every branch of book-keeping; an exact knowledge of commercial and corporation law; considerable acquaintance (gathered from actual experience) with the methods on which various kinds of business are conducted; and, in general, a liberal education. His training should always be obtained in the office of a duly qualified public accountant, and the measure of the degree to which he has profited by it is evidenced by the acquisition of such qualities as tact, caution, firmness, fairness good temper, courage, integrity, discretion, industry, judgment, patience, clear-headedness, and last, but by no means least, reliability.

II. Is it an auditor's duty to concern himself, to any extent, with the validity of the transactions that come under his notice? Explain.

This must largely depend upon circumstances. There are cases, e. g., corporation auditing, where it might be the auditor's duty to refuse his certificate upon the ground of invalidity in certain transactions. The scope of a corporation's business is stated in its articles of in-incorporation. Acts outside of this would be *ultra vires* and it would certainly be the auditor's duty to draw attention to the fact.

Charging revenue expenditure up as capital expenditure, or declaring dividends where no surplus exists out of which to pay them would be other examples, and would be grounds for the auditor's refusing his certificate.

Again: even in the case of a firm or individual, transactions may be such, and so recorded in the books, that the auditor's certifying to the correctness of same would make him particeps criminis in fraud; so the auditor must be continually on the alert.

III. Describe the steps necessary for a thorough and systematic audit of the accounts of a partnership business.

The articles of co-partnership should be examined and the partners' ledger accounts gone over to see that all provisions contained therein have been complied with. The cash balance in cash-book should be reconciled with the pass-book balance by means of a reconciliation account; stubs of check-book checked with cash-book, and cash-book entries vouched. All receipts should be

checked into bank, and the bank deposits in pass-book checked as to amounts and dates. The cash-book postings and footings should be carefully gone through; the postings and footings of sales, purchase and return-books checked, journal entires scrutinized, and the trial balances checked monthly. The closing entries should be gone over carefully; the matter of depreciation and reserve duly considered; and the correctness of the net earnings shown proved. The balance sheet should then be gone into in detail—each item receiving careful attention, and if full and correct the auditor will be justified in certifying to same. In the course of the work the petty cash-book, pay-rolls and inventories should not be overlooked, the latter being checked as to extensions and footings, and the values being compared with market prices.

IV. State the plan of procedure in making a thorough audit of the accounts and books of a corporation.

In addition to the work referred to in the answer to the preceding question (No. 3), in the case of a corporation the auditor should inspect the minute-book to verify the remuneration of officers; the declaration of dividends, and the authorization of all contracts of an unusual character. The transfer-book, check-book and stock-ledger should be carefully examined to see that the amounts of stock actually issued does not exceed the amount authorized. The necessity for differentiating between capital and revenue expenditure; of writing off an ample percentage for depreciation from assets subject to wear and tear and consequent diminution of value;

and of providing adequate reserves for discounts and bad debts, is even more absolute in the case of corporations than in the case of private firms; as in the latter case the members of the firm are always aware of the actual facts, while in the former case the auditor is relied upon by the public to take such protective measures for their interest in dealing with the accounts as he may deem best.

V. In auditing the accounts of a manufacturing company, what steps should be taken to verify the following assets: cash, bank account, bills receivable, accounts receivable, manufactured stock, real estate and machinery?

Cash: by actual count.

Bank account: The auditor should personally take the pass-book to the bank, request that it be written up to date, and returned to him personally. On its receipt he should compare the checks returned with the stubs of the check-book; then by deducting those unreturned from the pass-book balance, the resulting balance should agree with the check-book balance.

Bills receivable: These should be produced and inspected to see that none are overdue, that the names of the makers are good, and that the total amount agrees with the balance sheet total. If notes have been left at the bank for collection, a certificate should be obtained from the bank as to the amounts, dates, and other particulars.

Accounts receivable: The ledger should be gone through by the auditor in company with some responsible person who is acquainted with the amounts, and each

one examined seriatim. Doubtful debts should be transferred to a suspense account, and a reserve created for possible losses; bad debts should be charged to profit and loss account; good ones may be taken at face value.

Manufactured stock: This should be verified by checking the inventory as to extensions and footings and requiring the parties who took it to sign it. The auditor should see that it is taken at cost or market, whichever is lower; where cost-books are kept, a reference to them will be of material assistance in determining the correctness of the item.

Real estate and machinery: These may be verified by inspection of receipted bills, by seeing that revenue charges have not been capitalized, and by examining the ledger accounts to see that a proper percentage has been periodically written off for depreciation.

VI. In auditing a private banking institution, how would you ascertain the amount of checks that have been charged to depositors' accounts, but not presented for payment?

Presumably, such checks have been issued to customers at their request, made payable to various parties and charged at once to the depositor's account. Such checks should be made out from a "depositors' check book general." Cancelled checks paid would be at the bank and should be compared with the stubs of this check-book; stubs unmarked would show what checks had not been presented for payment,

VII. In preparing the balance-sheet of a business at the close of a year, how should *each* of the following be treated: (*a*) bad and doubtful debts, (*b*) premiums for fire insurance unexpired, (*c*) interest paid in advance on bills payable discounted, (*d*) depreciation of factory plant, store and office fixtures and similar items?

(*a*) Bad debts should be charged to profit and loss account; doubtful debts to a suspense account or doubtful debt ledger—a reserve for same being created.

(b) Premiums for fire insurance unexpired: A proportionate amount should be written off the insurance account to profit and loss account; the balance should represent the value of the unexpired portion of the policies which should appear amongst the asset on the balance sheet as a prepaid charge.

(*c*) Interest paid in advance on bills payable discounted: The discount account balance should be charged to profit and loss account, except such items as are referred to in the question. This balance should also appear on the balance sheet as an asset amongst prepaid charges.

(*d*) Depreciation of factory plant, store and office fixtures and similar items: The items may appear on the ledger and on the balance sheet at cost if profit and loss account has been charged, and a reserve account for depreciation credited with an adequate percentage of the cost. If this has not been done, then the percentage for depreciation determined on should be charged to profit and loss account and credited to the ledger accounts.

VIII. Write in proper form an auditor's certificate of correctness.

I have examined the books and accounts of X Y Z Co. for the year ending ——— and hereby certify as to the correctness of the net earnings shown in the profit and loss account annexed, and of the assets and liabilities shown in the balance sheet appended.

C. P. A.

IX. Under what circumstances, if any, would it be proper to open an account with goodwill? On finding a goodwill account on the ledger of a business for which you are to prepare the annual statement, how would you treat the account, or what special adjustment would you suggest in regard to it?

An account for good-will might be opened where a sum of money has been paid for the acquisition of a business in excess of the amount of the liabilities assumed over the assets acquired—a value placed upon it by the computation of the capitalized value of net earnings. Again, the initial expenses in starting a newspaper, magazine, or periodical—in short, establishment expenses might be charged to this account.

When the annual statement is made up the item should be placed as a separate item in the balance sheet so that no one can be misled on this subject. As it represents initial cost there is no *necessity* to write it down; but the auditor might *suggest* the advisability of writing it off by degrees to profit and loss account.

X. You have in hand the examination of the cash and bank account of a mercantile firm that uses checks very freely. Draft a reconcilement, bringing the cash-

book and bank pass-book into harmony at the close of the period under review.

Cash-book balance		$5,000
Check-book balance	$4,000	
Undeposited	1,000	
		$5,000
Pass-book balance	$5,000	
Less checks out..................	1,000	
Agreement with check book.......	$4,000	
Add. undeposited	1,000	
Reconciliation with cash-book............		$5,000

XI. What check has the auditor on fictitious entries showing purchases, and on returns of goods sold?

As to purchases, the auditor should compare the purchase-book and ledger entries with the purchase invoices, stock-book, statements, etc.

Returns of goods sold may be verified by copies of credit slips, reference to correspondence, receiving-book, stock-book, etc.

Cash purchases should always be vouched by receipted bills.

XII. In auditing the accounts of a gas company, what evidence of the receipt of amounts due from customers should be required?

Cash-book entries, stubs of receipt-books, bank deposits, comparison of amount of gas consumed, etc., with

total of charge columns, the deduction of total amounts received from which should leave a balance agreeing with the total of amounts outstanding and unpaid.

XIII. Should any fluctuation in the valuation of permanent assets be permitted to affect the result of the loss and gain account? Give reasons for your answer.

No. The profit and loss account is designed to show the loss or gain on trading for a specific period. If an increase or diminution in the value of permanent assets were recorded in that account, the loss or gain for the period would show a fictitious result. Such a variation should rather be treated as having a direct connection with capital rather than with revenue income or expenditure.

XIV. Expenditures are made by a corporation for items of *each* of the following classes: (*a*) taking down a machine in one part of a factory, moving it and putting it up in another part, (*b*) expenses of incorporating the company, including State charges and lawyer's services, (*c*) brokerage on purchase of a piece of property, (*d*) commission on an issue of debenture bonds, (*e*) costs attending a mortgage, (*f*) furniture and fittings of a city office and salesroom, (*g*) cost of patents, including solicitor's charges and government fees. Which items should be charged to capital and which to revenue? State reasons for your answer in each case.

(*a*) Revenue: the earning capacity is not necessarily increased by the operation.

(*b*) Capital: these are establishment expenses, and

should be charged off to profit and loss gradually until the whole amount is wiped out.

(*c*) Capital: it is part of the cost of the property.

(*d*) Capital: the charge should be written off by charges to profit and loss periodically during the term the bonds have to run.

(*e*) Revenue: it is an additional charge to interest on borrowed money.

(*f*) Capital: they are permanently necessary to the conduct of a business.

(*g*) Capital: the amount should be charged off to profit and loss account in amounts proportionable to the duration of the patents.

XV. The balance-sheet of a firm is summarized as follows:

ASSETS:		
Cash, stock and accounts receivable	$67,500	
Manufacturing plant	15,000	
LIABILITIES:		
Notes and accounts payable............		$49,500
Capital		37,500
	$82,500	$87,000

Would you consider this firm insolvent? Give reasons for your answer.

No. So long as the assets are equal to the liabilities (*exclusive* of capital) the firm is solvent. In this case they *exceed* them by $33,000.

January, 1901.

I. How should an auditor deal with customers' accounts outstanding at the date of closing books?

He should examine critically every open account in company with a member of the firm or with some responsible official (if a corporation) with a view to satisfying himself that the balances are good and collectable, or if not, that proper provision has been made in the form of a reserve for doubtful debts.

If accounts are found to be uncollectable (and the auditor should require the fullest explanations as to why they are so) they should be charged to profit and loss account at once.

Accounts about whose collection there is any reason to be doubtful, should be so classed, and a reserve created by a charge to profit and loss to provide for them. Accounts in good standing would, of course, appear in the regular way.

In determining the class to which each balance belongs the auditor should see that no outlawed accounts are admitted; that in all cases where the debtor has made an assignment the account is classed as doubtful; and that all balances consist of definite unsettled items, i. e., that the balances do not include disputed balances of old charges.

II. Assuming that you are limited as to time and fee in an audit embracing numerous personal accounts con-

tained in one general ledger, state precisely the steps you would adopt in each case to verify cash, sales, purchases, customers, creditors.

As to cash, I should check the footing of the cash-book and the footings of the monthly totals of receipts and disbursements into the cash account in the ledger, and see that the final balance agreed with the cash-book balance. I should next reconcile the cash and check-book balances by drawing up a reconciliation statement with the pass-book. Sales-book additions should be checked and the monthly totals compared with ledger postings. The same process should be adopted in checking purchases. From the trial balance I should extract the total amounts due by customers and due to creditors, and then raise controlling accounts by means of which these totals could be verified. Much would, of course, depend on time and fee. Where admissable, the cash transactions should be checked exhaustively.

III. What evidence should be required as to the correctness of the following assets shown on a balance-sheet: (*a*) land and buildings, (*b*) stocks and bonds, (*c*) notes receivable, (*d*) inventory of stock and supplies, (*e*) prepaid insurance?

(*a*) Land and buildings: the production of the title deeds, receipted bills of sale, examination of the accounts to see that only capital expenditure was included and that a proper amount had been periodically written off for depreciation.

(*b*) Stocks and bonds: their production for examination, or if hypothecated, certification as to equity therein; comparisons with market quotations, etc.

(*c*) Notes receivable: the production and examination of the notes, or if left at the bank, a certificate from the bank as to amounts, etc.

(*d*) Inventory of stock and supplies: the production of the inventory signed by the parties who took it; checking of extensions and footings; comparison with stockbooks; evidence that it has been taken at cost or market price, whichever is lowest; the application of the trading account gross profit percentage test.

(*e*) Prepaid insurance: the production of the policies, and the receipted bills for same.

IV. State generally what constitutes capital expenditure in *each* of the following cases: (*a*) a manufacturing company, (*b*) a gas company, (*c*) a charitable institution.

The following would constitute capital expenditure in the case of

(*a*) A manufacturing company: real estate, buildings, plant and machinery, furniture and fixtures.

(*b*) A gas company: real estate, buildings, manufacturing plant, machines, storage works, and other structures connected with manufacture, new mains and service pipes, meters, etc.

(*c*) A charitable institution: real estate, buildings, furniture and fixtures, permanent investments.

V. What proportion of $15,000—commission paid for negotiating a sale of bonds, to run 10 years—should be treated as an asset at the end of the first year? Give reasons.

In certain cases the whole of the commission might properly be charged up as capital expenditure, e. g., construction account, where bonds are sold to obtain the money to construct with. But ordinarily it would seem more reasonable to charge the commission to a "cost of bond issue account" and write off to profit and loss account annually such a proportion of the amount as would extinguish it at the time the bonds mature. On this basis of calculation, $13,500 should be treated as an asset at the end of the first year.

VI. To what documents should the auditor have access in *each* of the following cases: (*a*) partnership accounts, (*b*) trustee's accounts? Why?

(*a*) In the case of partnerships the auditor should have access to the co-partnership agreement in order that he may determine that its provisions have been complied with in the books of account. These would probably relate to the amount of capital to be invested and withdrawn by each partner; the proportion in which profits were to be shared; the charging or crediting interest on investments and withdrawals, and other matters incidental to the equitable sustenance of partnership relations.

(*b*) The auditor, in the case of trustees' accounts, should have access to the deeds of appointment, minute-book, and all legal documents, in order to satisfy himself that all statutory provisions have been duly complied with.

VII. In commencing an audit, say three months after the close of a fiscal year, how would you verify cash on

hand and bills receivable as they should stand at the end of such fiscal year?

With regard to cash the auditor should balance and rule off the cash-book on the day he commences the work and personally deposit in the bank all cash and checks on hand. He should obtain the pass-book from the bank when written up, and draft a reconciliation account so as to agree the check and cash-book balance with that in the pass-book. Then he should check backwards to the date on which the fiscal year ends. He would then have to audit the cash in the ordinary manner from the beginning to the end of the fiscal year.

As to bills receivable, he should check those on hand and those left at the bank for collection to see that the amount agrees with the total to the debit of the ledger account, and then compare each note-book entry to see that every note was collected, discounted, or charged back as dishonored, which appeared in the schedule of bills receivable at the end of the fiscal year.

VIII. What would be the effect on a statement of assets and liabilities of failure to charge depreciation against the following assets: (*a*) leasehold buildings, (*b*) fixed machinery, (*c*) loose machinery, (*d*) horses and trucks, (*e*) patterns and molds? Give reasons in each case.

(*a*) Leasehold buildings: being held for a limited time only, at the expiration of the lease the whole amount paid for the acquisition of the lease would become a charge against revenue account, and new capital would have to be introduced to obtain a renewal.

(*b*) Fixed machinery and (*c*) loose machinery—the effect to fail to charge off depreciation on a statement of assets and liabilities would be that the assets (and probably the surplus) would be overstated, and that dividends might be erroneously distributed out of capital, from surplus earnings being shown; whereas if depreciation had been charged, a deficit instead of a surplus might possibly have appeared.

(*d*) Horses and trucks: the former get old and die; the latter wear out—failure to write off depreciation causes an overstatement of assets with all the evils likely to accrue therefrom.

(*e*) Patents and molds: the former have only a limited life; the latter become old-fashioned and obsolete. If this depreciation in value is not provided for, the former becomes a dead loss of capital; the latter will have to be replaced by the introduction of new capital unless there is a sufficiently large amount of undistributed profits left in the business to offset it.

IX. What would you consider a satisfactory voucher for wages paid in a manufacturing business?

A satisfactory voucher for wages paid in a manufacturing business would be the production of a cancelled check agreeing in amount with the total of the weekly pay-roll, which (the pay-roll) had been properly made up, calculated, checked, paid out under a good system of internal check, and finally OK'd by the manager, one of the partners, or some responsible official.

X. In an audit of a business in which discounts are freely given and received and the accounts are charged

and credited in gross, what general check should be adopted in verification of (*a*) discounts allowed, (*b*) discounts received?

(*a*) A general check on discounts allowed might be obtained by extending the amounts of sales into various columns according to the various rates of discounts; by figuring out the discounts on the totals in gross; deducting outstanding accounts; and then comparing the result with the total discount allowed in the ledger account.

(*b*) As to discounts received, the auditor could only test by arriving at an approximate average percentage of the discounts on purchases for a few years past and comparing the result with that shown in the period under review. In the case of both discounts allowed and discounts received a close scrutiny of the various personal accounts should be made. It would be comparatively easy to find out which customers take advantage of their discount habitually and which do not—and thus a very efficient test could be applied. Where it is customary to use a columnar ledger to separate charges subject to various rates of discount the task of checking is considerably lightened.

XI. State the special uses to which an auditor may put controlling ledger accounts, such as "customers' ledger account," "purchase ledger account."

By the use of controlling accounts the general ledger keeper is able to take off a complete trial balance very rapidly without waiting for the verification of the totals of the individual accounts in the sales and purchase ledgers, and so the auditor can check the footings of the va-

rious books of original entry and the postings of the totals into the controlling accounts, and be certain that the balances shown are correct in gross. Where the accounts are numerous and detailed checking too lengthy to be practicable, the amount of time saved by the use of controlling accounts is enormous.

If each ledger is made self balancing the auditor can verify in a very short period of time the total amount of sales, purchases, discounts received and allowed, cash received and paid, returned purchases and sales; he can also maintain a check upon the general ledger trial balance. If the plan be adopted of changing the ledger clerks around periodically, fraudulent entries will be easily detectable.

XII. State what means should be adopted to verify (*a*) cash sales, (*b*) discounts allowed, (*c*) discounts received, (*d*) sold goods returned, (*e*) allowances on sales.

(*a*) Where cash sales are numerous, the method of verification will depend largely upon the system employed. Where carbon copies are preserved of all cash sales made, these should be compared with the daily cash slips, the totals checked, and compared with the daily entries in the cash book. But where this system is not in vogue, the detection of petty thefts would be almost a matter of impossibility. The auditor should find and approximate the average amount of daily or monthly cash sales and make use of his experience in determining what variations might be naturally expected in various kinds of businesses.

(*b*) With regard to discount allowed the auditor should apply the "law of average" test, and by examination of

individual accounts find out which customers are in the habit of availing themselves of discount and which are not.

(*c*) Discounts received can be verified by checking the actual cash payments to creditors and ascertaining that the discount agrees with the purchase bill terms.

(*d*) Sold goods returned should be checked and verified by reference to shipping receipt book, stock book, and stubs of returned goods credit book.

(*e*) As to allowances on sales, the auditor should go through these items with the head bookkeeper or a member of the firm and secure a reasonable explanation for each entry. The auditor would do well to recommend the introduction of journal vouchers—to be properly signed and to contain the reason for each entry. Where this is done this portion of the auditor's work can be performed rapidly and efficiently, and without having to waste time in worrying the facts out of an obstinate or unwilling subordinate.

XIII. Draw up a short report on the following balances sheet, criticizing such items as you consider abnormal:

Buildings	$87,500	Capital and surplus..	$155,000
Machinery	12,500	Current liabilities....	87,500
Sundry stock	90,000	Suspense account....	7,500
Cash	3,200		
Bills receivable	6,800		
Customers	20,000		
Goodwill and patents...	30,000		
	$250,000		$250,000

To A. B. & Co.,

DEAR SIRS:

I have examined the balance sheet submitted to me and beg to report as under:

I. It is unusual to put capital and surplus under one heading. The capital might be $100,000; the surplus $55,000. Were this so, the position of the company would be very different from what it would be were the capital $150,000 and the surplus $5,000! In the way the balance sheet is made up it is impossible to determine the amount of either capital or surplus.

II. The second item, "current liabilities," is indefinite. Of what do they consist? Notes have an awkward habit of falling due on certain dates fixed, whereas the payment of open accounts payable may sometimes be made in part or deferred.

III. The item "suspense account" certainly needs explanation. Is this a disputed liability, or is it a reserve account?

IV. With regard to the fixed assets it may be said at once that they are out of all proportion to those which may be called cash or quick assets—being $130,000 plus stock $90,000 as against $30,000: in other words there is available, supposing same could be immediately realized at face value, only $30,000 to discharge "current liabilities" amounting to $87,500—this of course is without taking into account stock $90,000, which would have to be sold—and which might shrink considerably in value during the process.

These matters are self-apparent—although in addition the questions would arise:

Has provision been made for depreciation?

How was stock valued?

Is there a reserve for bad and doubtful debts?
How were the good will and patents valued?

Yours truly,

C. P. A.

XIV. Given the following reconciliation of cash at the close of an audit, state categorically how it may be verified:

June 30, cash on hand as per cash book		$8,549.17
Balance as per bank pass book at close of business	16,549.72	
Add check of J. B. Jones, not deposited	1,450.00	
	17,999.72	
Deduct checks drawn, not presented	10,154.29	
	7,845.43	
Cash in drawer	703.74	$8,549.17

Balance as per pass book: this should be verified by the auditor taking the pass book to the bank personally and obtaining a certificate or the verbal assurance of the bank cashier that the balance shown in the pass book at that particular date agreed with the bank ledger account—that the pass book is genuine, and the balance shown correct.

The check of J. B. Jones not deposited should be produced and the auditor should see that it is included in the amount entered in the cash book prior to the balancing and closing of the cash book.

Checks drawn and not presented should be verified by (1) the auditor checking all stubs with the cash book

entries; (2) by marking the stubs of those checks returned by the bank; (3) by listing and totalling the stubs unmarked; said total deducted from the pass book balance should agree with check book balance.

Cash in drawer should be verified by the auditor actually counting it.

This method is on the assumption that the auditor is present at the time the cash book is closed at the end of a fiscal period. Should his auditing commence at some later date, it would be necessary for him to check *backward* from the date at which he begins the cash verification to the date of closing.

XV. A corporation sells its first mortgage bonds at $10,000 premium and its second mortgage bonds at $10,000 discount. Give your views as to the proper treatment of these items of premium and discount.

As these items counterbalance each other there would be no objection to crediting the premium and debiting the discount to profit and loss account.

On the other hand, supposing the bonds were "short timers"—say ten years, the charges and credits might be spread over that period so that their disappearance might be synchronous with the redemption of the bonds.

June, 1901.

I. Give a brief outline of the duties and responsibilities of an auditor. What special qualifications should an auditor possess?

The duties of an auditor are to examine the books, papers, and all data submitted to him bearing on the accounts he is called in to review, and to test their accuracy so as to enable him to certify to their correctness. This examination he should conduct on such lines as would enable him to detect errors of principle, technical errors, or fraud. In business enterprises the objects he should have in view should be the ascertaining that the earnings for any given period are correctly stated, and that the balance sheet contained a correct statement of assets and liabilities on a certain given day.

As to his responsibilities—they may be classed as moral and legal.

He is morally responsible for the correctness of all the accounts and statements to which he certifies; he may be made legally responsible if he intentionally so certifies to misrepresentation of facts that others suffer loss or injury thereby.

The special qualifications an auditor should possess are numerous. He should have a thorough knowledge of bookkeeping, mathematics, and commercial law; an intimate acquaintance with the methods of conducting various lines of business; and such personal qualities as tact, an even temper, patience, and good judgment.

II. Without definite instructions, what, in your judgment, would constitute a thorough and proper audit of a set of books?

The cash balance on hand should be verified by actual count; the bank balance as per pass book by the construction of a reconciliation account—agreeing check book balance therewith; the stubs of check book should be compared with cash book entries, and the deposits compared with the pass book entries as to dates and amounts of same. The cash book footings and postings should be checked, and all payments vouched. The footings and postings of all books of original entry should be checked into the ledger; journal entries should be scrutinized as to their correctness and manifest propriety, and the classification of income and revenue expenditure be constantly borne in mind. Bills receivable and payable accounts should be compared with note and cash book entries. The inventory should be checked as to extensions and footings; the closing entries carefully examined—care being exercised to see that ample provision has been made for depreciation, bad debts, discount, etc., and finally the balance sheet drawn up in proper form, and if correct, certified to. Pay-roll books, and petty cash should receive due attention, and an unceasing alertness for the detection of fraud maintained throughout the audit.

III. What are the principal points to which attention should be given in ascertaining the amount of the net earnings of a company desiring to use your certificate?

To ascertain that no outlays chargable against revenue had been capitalized; that proper provision had been periodically made for depreciation; that such items as

interest on loans, etc., were stated separately; that profits of an extraordinary nature, extraneous to the ordinary business of the company were excluded; that the inventory had been taken at cost or market, whichever was lowest; that reserves were created for bad debts, discounts, etc.; that the percentage of gross profit was consistent with that realized in former years; and that the result disclosed in the profit and loss account was corroborated by the balance sheet.

IV. What evidence should the auditor require as to the authority given to officials of a municipal corporation to expend money? State what methods should be used in auditing the actual payments.

He should ask for the minutes of the meetings of the controlling board of the municipality and ascertain that the officials whose signatures validate disbursements have been duly elected or appointed; and that a finance committee has been chosen.

With respect to the audit of actual payments he should see that all warrants are properly recorded and charged in a warrant register; that they are signed by the proper officials; that there is on file an attested copy of every resolution authorizing a payment, with a voucher or bill passed by the finance committee and signed by the payee.

In the payment of matured bonds he should see that they are on file and so mutilated as to be absolutely unusable.

In the payment of interest he should see that the interest is due as per records in Bond Register, and if coupon interest that the paid coupons are on file, so mutilated as to prevent re-presentation. If the bonds or coupons are not on file he should ascertain by a com-

parison of the municipality's accounts with the depository where such bonds and coupons are payable that they are legitimately outstanding—as non-presented.

Redeemed certificates of indebtedness should also be on file and cancelled.

Payments to Sinking Fund should be verified from the records of the Sinking Fund Commissioners.

All returned warrants, bonds, coupons, and certificates of indebtedness should be stamped or initialled by the auditor himself.

V. How should the accountant proceed if required to audit the accounts of a firm which kept only a cash book and journal, but had preserved all the invoices and vouchers pertaining to the business?

The audit of the cash book should be made in the usual manner. As all vouchers have been preserved there should be no difficulty in vouching payments; bank transactions can be verified by check book and pass book.

As all sales have been journalized—the deduction from the totals charged of the amount of cash received should show the amount of accounts receivable outstanding. This could be verified by comparing cash book receipts with journal charges, and sending out statements to customers of unsettled bills. As all purchases have been journalized—the entries can be compared with invoices and the total amount of accounts payable determined by deducting total cash paid as per cash book with total credits through journal. The amount can be verified by checking payments with credits, listing outstanding accounts, and obtaining statements from creditors in confirmation.

Partners' investments and withdrawals should be checked, profit or loss determined by a comparison of assets and liabilities, profit or loss divided, and a final balance sheet drawn up.

As all bills are preserved the auditor should have no difficulty in arriving at the value of assets other than accounts receivable.

VI. State briefly your views as to the question of depreciation of assets, and the rule which you adopt in regard to it. What rates would you apply to plant and machinery, and furniture and fixtures?

It has been ably remarked by Mr. Edwin Guthrie that "depreciation, in relation to accounts, affects both capital account and profit and loss account."

In respect of capital, it is the measure, as between an earlier and a later date, of the reduction in value of any given property. In relation to profit and loss it enters as an element in the cost of manufacture represented by the deterioration by wear and tear, decay, or reduction of value arising by reason of age and use of buildings, fixed and loose machinery and plant of every description employed in the production of things produced for sale or disposal in the ordinary way of trade. As an ultimate result of this employment, these items constitute an element in the cost of production.

As a corollary to this my rule is to fiud out what assets are subject to wear and tear, or impairment through flux of time and to see that a proper percentage has been periodically written off to profit and loss account.

Plant and machinery should be subjected to depreciation offset at from five to ten per cent. on diminishing

value; furniture and fixtures, seven to twelve and a half per cent. on diminishing value.

VII. What is meant by the term sinking fund? Show how a sinking fund is opened or established, and explain its operation from year to year.

A sinking fund is a fund set aside out of assets and accumulated at interest for the purpose of meeting a debt.

Having determined the sum necessary to be set aside, which will amount, with interest, in a certain number of years to the amount of the debt which it is designed to liquidate, this sum is annually charged to revenue or income account and credited to sinking fund account. The amount is then invested annually and the investment termed sinking fund. The interest is periodically reinvested, added to the sinking fund and credited to sinking fund account. Finally the fund is converted into cash, the fund credited, and the indebtedness (generally in the form of bonds) charged and wiped out. The sinking fund account then becomes a surplus.

VIII. Explain the difference between an account of receipts and payments and an account of income and expenditure.

An account of receipts and payments is one which shows the actual amount of *cash* received and paid during a certain period. Starting with the balance of cash on hand at the beginning of a fiscal period, there should be added to it the total of all cash received; the total cash paid out being deducted should show the balance of cash on hand at the end of the period.

An account of income and expenditure shows the total income from all sources (whether collected or not) for a certain period, and the total expenditure (whether paid or not): the excess of the income over the expenditure is called the net income, net revenue, or net profit. We are suffering apparently from a redundancy of terms, all meaning the same thing; all designed to show the same result. Thus an income and expenditure account, revenue account, and profit and loss account are all designed to show the net income, earnings, or profit for a specific period.

IX. In auditing the books of a building and loan association, what method should be used in verifying (*a*) depositors' pass-books, (*b*) mortgages held by the association, (*c*) the income?

(*a*) Each pass book should be produced and every entry checked with the contribution book, stockholders' ledger, withdrawal book, treasurer's receipt book and cash book. Care should be exercised to ascertain that each member has paid all necessary fees, and that before each pass-book is issued all the requirements of the association have been complied with by the holder.

(*b*) As to mortgages, the title deeds should be examined, receipts for cash verified, interest charges and receipts calculated and checked, and the fact ascertained that they are systematically recorded and safely kept.

(*c*) As to income the auditor should ascertain and list the sources whence the income is received, verify cash book receipts and vouch all payments; see that all expenditure is duly authorized, and prove the existence of the cash balance shown in the cash book.

X. How should the auditor deal with the ledger accounts of partners (*a*) in the division of profits, (*b*) in the assessment of losses, (*c*) in case a partner's drawings exceed the amount specified in the partnership agreement, (*d*) in case a partner's drawings are less than the amount to which he is entitled?

In dealing with the ledger accounts of partners the auditor should always ask for a copy of the co-partnership articles of agreement, and his aim should be to see that all provisions therein have been duly complied with.

(*a*) In the division of profits, if there is no stipulation as to the proportion of same to be taken by each partner, in the articles of co-partnership, then the profits must be divided equally—irrespective of the amount of capital invested by each partner. The auditor should see that each partner is so credited. If the profit is agreed to be shared in definite proportions then the auditor should see that this is given effect to on the ledger.

(*b*) In the assessment of losses reference should again be made to the partnership articles. In the absence of specific agreement losses should be borne equally.

(*c*) In case a partner's drawings exceeds the amount specified in the partnership agreement, he should be requested to replace the amount overdrawn by cash or note, and be charged with interest on the actual overdraft.

(*d*) In case a partner's drawings are less than the amount to which he is entitled, he may, by consent of his partner, be credited with interest on the difference.

XI. What rules would you recommend for localizing the errors in a trial balance?

There are many rules; but only one of them which

never fails—check footings of books of original entry and ledger accounts, postings, extraction of balances, and footing of trial balance book.

Where the ledgers are made self balancing and controlling accounts exist, the errors can be easily localized; but where they do not, the only alternative is to construct them or "check back."

If the difference is exactly divisible by nine—transposition of figures may be looked for; if by two, look for double or half the amount on the wrong side of the trial balance.

XII. What routine would you recommend in the checking of invoices of goods or materials purchased?

All invoices should be stamped on their receipt with a blank form showing date received, signature of receipt of goods by receiving clerk, signature of person who ordered the goods with O. K. as to prices and quantity, and signature of stock clerk. On the invoices being passed into the office they should be checked as to extensions and footings by a designated clerk, who should initial same on completion of his work. They should then be passed over to the bookkeeper for entry in the purchase book and ledger, and the folio of the purchase book in which they are entered should be marked on each invoice. They should then be filed under that particular date when the best discount is obtainable.

XIII. A company manufacturing a proprietary article offers certain premiums to its customers on the return of its wrappings, the premiums offered being indicated in a published schedule. At the time of making out the

annual balance sheet, only a few of the premiums have been distributed. How should this matter be treated in the balance sheet?

The value of the premiums should appear at cost on the balance sheet and a reserve account for the same amount appear as a liability. As issued the value of the premiums could thereafter be periodically credited to the premium account and charged against the reserve account.

XIV. In the case of a company which has issued preferred stock carrying a cumulative dividend, but has not earned enough to pay such dividend in full for several years, how would you deal with the arrears of dividends due, if at all, on the company's balance sheet? Give reasons.

The arrears of unpaid dividends should not be dealt with in the balance sheet, but in the auditor's report. The liability of a company in the matter of dividends to its stockholders is only contingent upon their *being earned*. The preference only extends to this: the stated amount and rate of dividend must be paid to preferred stockholders before any dividend can be paid to holders of common stock.

XV. Explain the difference between capital expenditure and revenue expenditure. What rule controls in determining whether certain payments belong to capital or to revenue? When in doubt, to which should the payment be charged?

Capital expenditure is the replacement of one form of asset by another, *e. g.*, cash by buildings, plant and ma-

chinery, etc. Revenue expenditure is that which is made to conduct a business, but by means of it, no permanent asset is acquired.

In short, capital expenditure appears upon the balance sheet; revenue expenditure is charged to profit and loss account; this is the broad, general distinction, and is the answer to the second section of this question—what rule controls in determining whether certain payments belong to capital or to revenue?

When there is a doubt, the payment should be charged to capital account. Should this afterwards prove to have been erroneous, it is a simple matter to transfer the item to the revenue account; but after the charge has once been made to revenue account and that account closed, considerable explanations would have to be forthcoming to explain the matter.

January, 1902.

I. What should the auditor require of a company or firm whose books he is to audit?

He should require the books to be written up to date, the cash book balanced, a correct trial balance to be forthcoming, all checks and vouchers to be produced, arranged methodically, a list of all the books of accounts with the dates they cover, and the names of the employees by whom they are kept.

If a corporation, he should require, in addition, the minute book to be written up and produced for examination, the transfer book to be written up, and the stock ledger forthcoming in balance. In the case of a partnership, the articles of co-partnership should also be asked for.

The auditor will now be able to ascertain the extent and scope of his work, and decide on the best method of conducting his work and of the means to be adopted to bring it to an effective conclusion.

II. Describe in detail your method of conducting an audit of a manufacturing corporation desiring your certificate, where no instructions have been given as to the extent or scope of the audit.

In such a case the audit should be exhaustive. The cash book should be checked thoroughly; the balance therein at the end of the period under review reconciled

with the pass-book in the usual manner; all receipts checked into bank, and all payments out by stubs of check book and vouchers.

Sales and purchase books should be checked as to footings and postings; journal entries examined and checked into ledger; the trial balance tested; the manufacturing account, trading account, and profit and loss account gone over. The pay-rolls should be checked, and special attention paid to such accounts as plant and machinery, buildings, etc., to see that no charges for repairs and renewals were included, and also that adequate provision had been made for depreciation. Where a proper cost system is in operation the cost books should be carefully gone over to see that the material consumed and labor expended resulted in the production of the proper quantity of manufactured goods. The inventory should receive special attention. It should be signed by the parties who took it, and the auditor should check its extensions and footings.

Raw material should be taken at cost or market, whichever was lowest; manufactured goods at cost of production; partially manufactured goods according to the extent to which they have approached completion.

The accounts receivable should be examined seriatim and reserves created for doubtful debts and discounts. The percentage of gross and net earnings should be compared with that of former years, and finally the balance sheet gone over to ascertain that the assets and libilities were neither under nor over-stated, so that the auditor could certify that it was "full" and correct.

III. In an audit of the books of a corporation using the voucher system, what means should be adopted to

prevent the reproduction of vouchers already passed, in cases where the auditor is not permitted to deface the vouchers by stamps or writing?

While the audit is in progress the auditor should keep all passed vouchers in his own possession.

When all the vouchers are passed they should be handed over to a responsible official for safe keeping—preferably, in sealed packages.

IV. Describe in detail the method that should be used to verify the securities representing the investments of a company under audit, in the case of (*a*) real estate, (*b*) mortgages on real estate, (*c*) certificates of stock, (*d*) railway bonds.

(*a*) In the case of real estate the most satisfactory evidence would be the production of the title deeds, receipted bills and checks showing cost. The auditor would have to exercise great care to see that all items charged to the account were capital expenditure—*e. g.*, expenditure for improvements should be charged, but not maintenance expenses.

(*b*) Mortgages on real estate should be verified by production of the checks paid out and of the deeds themselves. The recording thereof should be examined, and the matter of interest thereon carefully looked into.

(*c*) Certificates of stock should be produced simultaneously with

(*d*) Railway bonds. They should be examined, counted, and listed. Their value should be determined from market quotations and all other available sources of information. The auditor should take the precaution to ascertain their genuineness also.

If the bonds are coupon bonds, he should see that the coupons are attached, and that all those paid since the date of the acquisition of the bonds have been duly entered in the cash book.

V. How may the auditor know that the balance sheet and profit and loss account of his client have included all income and expenditure applicable to the period under review?

By making first a complete audit of the books of account, and thoroughly familiarizing himself with the methods employed in conducting the business, the sources of income, and the nature of the expenditure. These will vary more or less in every undertaking, and the auditor must be guided mainly by his experience in determining the fact. He has one final test, in that the profit disclosed by the profit and loss account must be always confirmed by the balance sheet.

VI. What means should the auditor adopt to ascertain that all remittances made by regular customers and receipts from cash sales have been properly entered on the cash-book?

With regard to the remittances made by regular customers he may obtain confirmation of their correct entry by examining each account, noting the terms of payment, and the general way they have of paying.

If accounts are generally settled monthly and the auditor finds remittances uncredited, he should request an explanation from the cashier or a member of the firm, and if the explanation is not satisfactory, a statement

should be mailed by the auditor personally requesting that it be returned to him marked correct or otherwise.

As to cash sales, the auditor should ascertain carefully the method of handling them and act accordingly. A considerable shrinkage on any particular day would of course need explanation.

If carbon sales stubs are preserved these may be compared with the cash sale sheets. Petty thefts would be very difficult to detect—but were they conducted continuously on a large scale the deficiency would be evident in the trading account.

VII. An auditor, on completion of his work, certifies that the accounts are correct in accordance with the books. Is this form of certificate subject to criticism, and if so, why?

It is: because the accounts may be correct in accordance with the books, and yet the books may not record facts faithfully, and it is this point, whether they do, or do not, which the auditor should determine from his work. If they do, he should so certify; if they do not, he should refuse to give a certificate.

VIII. What general principle should an auditor apply in distributing expenditures regarding which his client is uncertain as to whether they should be charged to capital or to revenue account?

If the expenditure is for a permanent asset, or is of such a character as to increase the earning capacity of a business, the charge should be made to capital account; if not, to revenue account. If there is any doubt on the matter, capital account should be charged.

IX. After auditing the books of a manufacturer annually for a period of 10 years, you are asked to render a certificate as to the net earnings of the business for those 10 years, for the purpose of a sale based on the earning capacity of the property. What items of expense heretofore charged annually through the profit and loss account may be properly eliminated in the preparation of your certificate, and why?

The following items might be properly eliminated:

Interest on bills payable and all loans, because an insufficiency of working capital entailed the charges, which would not have been incurred had there been adequate funds available for conducting the business.

Interest on capital should be also eliminated, as it is a charge against earnings which in the case of a corporation would be available for dividends.

X. When auditing the books of a firm engaged in mercantile business, on what principle should the auditor proceed in determining whether an account receivable should be classed as good, bad or doubtful?

If the accounts are outlawed by the statute of limitations they should be classed as bad, as should also those of discharged bankrupts. If a firm is in liquidation, or if it has made an assignment, or if legal proceedings have been instituted for the recovery of the amount of the account, the account should be classed as doubtful. Where the accounts are settled at regular intervals, and the balances consist of specific bills unpaid, and do not include balances of old disputed items, they may be classed as good. The credit and standing of the debtors may always be determined from trade-rating books, etc., in confirmation or otherwise of the opinion the auditor has formed.

XI. What are the most important things to which an auditor is expected to certify in (*a*) the balance sheet, (*b*) the profit and loss account?

(*a*) In the balance sheet the auditor is expected to certify that it is full and correct; that the assets and liabilities are neither over nor under-stated; and that it is a correct statement of the financial position of a concern at a given moment of time.

(*b*) In the profit and loss account the auditor is expected to certify that the earnings are correctly stated, and that all expenditures and income properly chargeable or creditable therein have been included, whether same have been actually paid or received during the fiscal period the account covers or not.

XII. Explain *two* methods by which depreciation on buildings, machinery and plant may be stated in the books of account. State which method you prefer and give reasons.

I. A certain percentage of the original cost may be annually written off, based upon the supposed life of the assets, and thus the total cost is charged to revenue account by equal periodic installments.

II. A certain percentage may be written off on the diminishing value periodically until the residual value is arrived at.

The second method is generally preferable because while in the first case the amounts written off do not vary, yet value is eventually extinguished, and there is generally some residual value remaining.

In the second case the amount written off diminishes periodically—and while the greater amount is written off

at first when there is the least wear and tear, this is offset by the fact that in the latter years the amounts expended for repairs are greater.

In the books of account depreciation may be

I. Charged to Profit and Loss Account and credited to a reserve for depreciation account; or

II. Charged to Profit and Loss Account and credited to the specific account depreciated.

XIII. What is meant by a suspense account? Give *three* instances of items carried to a suspense account, and state how they may be removed from that account.

A suspense account is an account opened for the purpose of having posted to it items which the bookkeeper is unable for the time to determine the proper account to which they should be posted. (Lisle.)

I. A doubtful debt may be credited to the debtor's account and charged to suspense account. When its value is determined, suspense account may be credited, and profit and loss account charged if bad; cash charged if good; or proft and loss and cash charged if part of the debt is paid and the balance pronounced uncollectable.

II. An item of cash may be received and the sender's name overlooked. The amount should be credited to suspense account, and when the payer's name is ascertained the account should be debited and the payer's account credited.

III. A dispute may arise as to the liability of a firm to one of its creditors. Pending settlement the suspense

account is the proper recipient of the credit. When the matter is settled, the amount should be debited to suspense account; the creditor credited with the amount decided on, and that account credited with the balance which originally was charged with the full amount credited to suspense account.

XIV. What principle should be applied in valuing the stock of material and supplies on hand, and to what extent is the auditor responsible for this item in the balance sheet?

Material and supplies on hand should be valued at cost or market, whichever is the lower.

The auditor, while not a professional valuer, should consider himself responsible for the correctness of the inventory of these items as to calculations and amount.

Any gross overvaluation would of course manifest itself in the trading account and the auditor would then know what steps to take. It is always well for the auditor in his certificate to "except as to inventory"—the valuation of which he has accepted as made up by Messrs. So and So.

XV. When auditing the books and accounts of a concern operating a large machine shop you find that the machinery and tools have been regularly depreciated each year, that their value as shown by the books is considerably less than the value as shown by an independent appraisal, and that the firm has set up the higher values as shown by the appraisal on the books. To what account would you recommend the corresponding credit to go, and for what reasons?

The corresponding credit should go to a reserve for depreciation account, because were it credited to profit and loss account the profit would be inordinately swollen, while there would be no corresponding increase in the amount of net earnings available for withdrawal. If preferable, in the case of an ordinary firm there would be no objection to the amount being credited to capital instead of to reserve for depreciation.

June, 1902.

I. Describe fully the duties and work of an auditor for a manufacturing concern, stating in detail the order in which the audit should be carried through, and drawing attention to those points in the accounts which should receive special care.

In the audit of a manufacturing concern the cash transactions, as in every other class of business, should be first verified: receipts by checking deposits; payments by checks, receipted bills and other vouchers; the balance on hand as per cash book at closing date by reconciling check book balance with pass-book balance.

The footings of the cash book should be gone over and the postings checked.

All sales books, purchase books, return books, and journal should be footed and the postings checked.

The trial balance book should be verified; the closing entries checked; and the balance sheet items gone over seriatim. The petty cash book and pay-rolls should receive careful attention. All purchases of material and supplies should be checked into the various stock books, thence into the consumption books, and the output of manufactured goods verified. All inventories should be checked as to extensions and footings, etc., compared with market values.

The trading account should be examined and the percentage of gross profit compared with that of former years.

The costing system should be examined and tested as to adequacy and accuracy. Care should be exercised that the distinction between capital and revenue expenditure has been adhered to in the accounts; that ample provision has been made for depreciation, and that reserves have been set aside for bad debts, discounts, etc. Accrued assets and liabilities should be carefully figured out and included in the profit and loss account and balance sheet.

Bills receivable and payable should be made up in schedules and compared with the balance sheet items under these heads. Opinions would differ as to the exact *order* in which the audit should be made; but conducted on the above lines a fairly comprehensive review of all the important points may be fairly said to be included.

II. State your views as to the functions of the journal. In what does it differ from the cashbook?

The function of the journal is to act as a book of original entry for all transactions for which no other independent books of record exist. Thus the opening and closing entries, and *transfers* from one account to another could scarcely be made with propriety in any other account book.

The cash book records all cash received and expended; is a book of independent original entry; and capable of independent proof. In some concerns it is still the custom to pass *all* entries through the journal; but the same results are obtainable with a great saving in labor, by the use of separate books of original entry, and the adoption of the columnar system.

III. Draft a bank reconcilement account, dealing with checks outstanding, not cleared.

Pass book balance		$5,000.00
Check book balance	$4,000.00	
Add checks outstanding not returned by bank	1,000.00	
Reconciliation with pass book balance		$5,000.00

IV. Describe the various steps to be taken in auditing the accounts of an executor for the first year after the death of the testator.

The auditor should ask for a copy of the will, letters testamentary, and appraiser's inventory. He should make himself thoroughly acquainted with their contents, and see that the accounts have been opened in such a way as to give adequate expression to same. If a minute book has been kept of proceedings in surrogate's court, it should be carefully inspected. Check books, returned checks, and receipted vouchers should be gone over and checked with the cash book. All securities should be inspected and the cash book balance reconciled with that of the pass book. He should see that the distinction between principal and income has been rigidly adhered to in the accounts and make such further examination as would enable him to certify to the correctness of executor's transactions.

V. Draft a form of auditor's certificate to be attached to a balance sheet on completion of an audit of the books of a manufacturer.

I have audited the accounts of Mr. A. B. and certify to the correctness of same.

The balance sheet above is full and a complete statement of his assets and liabilities at the close of business on ——— 1905. I have accepted the values in the inventory as signed by Mr. C. D. C. P. A.

VI. A corporation has an issue of preferred stock entitled to cumulative dividends of 7% a year. The company has paid on this stock dividends at the rate of 5% a year for ten years. Should the arrears of dividends appear on the balance sheet, and if so, how?

The arrears of dividends should not appear amongst the liabilities on the balance sheet, as the corporation's liability for dividends on preferred stock are only contingent on their being earned. In this case as a suppression of the facts might work to the disadvantage of prospective common stock purchasers, it would appear desirable that the auditor should draw attention to the fact in a note at the foot of the balance sheet to which he appends his certificate.

VII. It is found in an audit that certain merchandise shipped to an agent for sale has been charged to his personal account and credited to sales. Make correcting entries.

Sales, Dr.
  To Agent's Personal account.
Agency Account, Dr.
  To consignment account.

VIII. What is the difference between a reserve and a reserve fund? Give examples of each.

A reserve or reserve account is created by charging the revenue account and crediting a specific reserve account with a certain amount. Thus, while the amount of the reserve is included amongst the assets, there is no particular asset which corresponds to it—*e. g.,* reserve for bad debts. When an account is pronounced uncollectable, the amount may be credited to the debtor and debited to the reserve account which has been created and provided for this purpose.

A reserve fund is a *cash* asset and is an amount reserved for some specific purpose; *e. g.,* Building reserve fund: when the fund reaches the required amount, the building is purchased or built with the amount set aside for that purpose.

IX. What points require special attention in examining bills receivable at the end of a fiscal period?

The notes should all be produced and examined; if left at the bank for collection, certified particulars should be obtained from the bank. The dates should be examined to see that none are overdue; the amounts, to see that the total agrees with the ledger account; the makers' and endorsers' names, so that inquiry may be made as to their credit.

X. What is meant by depreciation? Mention *four* items of assets subject to depreciation in the balance sheet, and state the annual rate that you would recommend to be charged.

By depreciation is meant diminution in value consequent on wear and tear, lapse of time, etc.

Horses and wagons	20 per cent.	
Plant and machinery	5 to $7\frac{1}{2}$	"
Buildings	$2\frac{1}{2}$	"
Furniture and fixtures	10 to $12\frac{1}{2}$	"

XI. How should the following assets be valued in preparing a balance sheet: (*a*) manufactured goods, (*b*) accounts receivable, (*c*) goods in process of manufacture, (*d*) bills receivable?

(*a*) Manufactured goods, at cost;

(*b*) Accounts Receivable, if good, at face value; if doubtful, a reserve should be created to cover the amount; if bad, at nothing.

(*c*) Goods in process of manufacture should be valued at the extent to which they have approached completion —cost of material and supplies, labor, proportion of fixed charges, etc.

(*d*) Bills receivable, if current, should be taken at face value.

XII. How should the discount and premium arising from the sale of a company's own securities held in its treasury be treated on the books? Give examples.

Taking bonds as an example: if they be sold at a premium, the par value received should be credited to the bond account, and the premium received to a bond issue premium account. This latter could be closed out to profit and loss account at the end of the next fiscal period; or could be transferred to the credit of a reserve account in connection with the purpose for which the bonds were issued.

If the bonds are sold at a discount, the discount could be charged to a "cost of floating bonds" account.

This might be closed out by charging it as part of the cost of the asset for the acquisition of which the bonds were issued. On the other hand it might be closed out by periodically crediting it with and charging to revenue an amount proportionate to the time the bonds have to run.

XIII. What are the special points to which an auditor's attention should be directed in examining and verifying an inventory consisting of raw stock, supplies, goods in process and manufactured goods?

As to raw stock and supplies he should require the inventory to be signed by the parties who took it.

He should see that the prices are cost or market, whichever is lower. Goods in process and manufactured goods should be taken at actual cost of production. He should verify this by comparison with cost books.

In all cases he should check extensions and footings.

XIV. In auditing the accounts of a firm comprising several partners, to what *three* points should particular attention be given in ascertaining whether the partners' accounts are correctly stated in the balance sheet?

Having audited the cash transactions, he should see

(1) That each partner has contributed the amount of capital stipulated in the partnership agreement, and that he has been credited therewith. Having made up the profit and loss account, he should see

(2) That each partner has been credited with his

proper proportion of the profits, or charged with his share of the losses:

(3) That if it is agreed on in the partnership articles that interest is to be credited on investments and charged on withdrawals such provision has been complied with.

XV. Draft journal entries showing how a sinking fund of $5,000 a year should be provided for retirement of an issue of bonds.

Revenue Account, Dr., $5,000.
To Sinking Fund Account $5,000

Sinking Fund, Dr., $5,000.
To cash $5,000